

**For Information
On 8 November 2004**

**Legislative Council
Panel on Information, Technology and Broadcasting**

**Moving from *Ex Ante* to *Ex Post* Regulation of the Tariffs
of PCCW-HKT Telephone Limited**

INTRODUCTION

This paper briefs Members on the consultation exercise launched by the Office of the Telecommunications Authority (OFTA) on 8 October 2004 on the proposed change in the regulation of the tariffs of PCCW-HKT Telephone Limited (PCCW-HKT). The consultation period will end on 19 November 2004.

BACKGROUND

2. On 23 September 2003 and 28 November 2003, OFTA issued two consultation papers on PCCW-HKT's applications for declaration of non-dominance in the Business Direct Exchange Lines and Residential Direct Exchange Lines markets respectively. In those consultation papers, the possibility of implementing *ex post*¹ regulation on PCCW-HKT's tariffs as an alternative regulatory approach was raised.

3. After further considering the merits of the existing and alternative regulatory approaches, the Telecommunications Authority (TA) considered that the approach of implementing an *ex post* regulatory regime on the tariffs of PCCW-HKT was worth pursuing. Accordingly, OFTA launched a separate consultation exercise on 8 October 2004. The consultation paper issued for this separate consultation set out the proposal

¹ *Ex post* regulation generally means that the regulator can impose sanction against an operator after it has abused its dominant position, or engaged in other anti-competitive conduct.

to replace *ex ante*² regulation on the tariffs of PCCW-HKT with *ex post* regulation through the issuance of a new Fixed Carrier (FC) licence.

THE CONSULTATION PAPER

Fixed telephony services in Hong Kong

4. Historically, fixed telephony services were provided by PCCW-HKT³ as a monopoly operator until 1995. The Government progressively liberalised the fixed telephony market. By 2003, the fixed telephony market is fully liberalised without any regulatory limit on the number of licences for the provision of fixed telephony services. Currently, there are 11 licences in total. As a result of competition from the new entrants into this market, PCCW-HKT's market share has gradually declined and is around 70% at the moment.

5. Since 1995, the TA has implemented various regulatory measures including road opening coordination, facilitating in-building access, open access to in-building wiring, number portability, as well as mandatory Type I and Type II interconnection. These measures all share the common policy objective of lowering the barriers to entry for the provision of fixed-line services.

6. Earlier this year, the Government announced a new regulatory policy on Type II interconnection which will be progressively implemented till 2008, upon the satisfaction that barriers are not significant enough to deter facilities-based entry to customer access networks for buildings accommodating up to 75% – 80% of households.

7. Apart from new competition from fixed telephony operators, new services such as mobile and voice over Internet Protocol (VoIP) services have emerged. These new services are challenging the 'necessity' status of traditional fixed line services for consumers. In 2002, fixed telephony accounted for only around 16% of total telecommunications services revenue in Hong Kong. Moreover, the number of subscribers for mobile services has already exceeded that for fixed lines.

² *Ex ante* regulation generally means that an operator must seek the regulator's prior approval for tariff pricing, including launching discounts or price promotions.

³ Then known as Hong Kong Telephone Company Ltd

Existing tariff regulation on PCCW-HKT

8. The present regulatory procedures on PCCW-HKT's tariffs for various telecommunications services operated under its Fixed Telecommunications Network Services (FTNS) licence were established in 1995 when the TA issued the licence following the liberalisation of the fixed telephony markets. As PCCW-HKT had enormous market powers at the start of liberalisation, it was presumed dominant for the purpose of tariff supervision under its licence, unless and until the TA forms the contrary opinion. There has been no such opinion to date in relation to PCCW-HKT's fixed telephony services.

9. As such, PCCW-HKT remains obliged to apply to the TA for prior approval for every individual discount, promotion or change in tariff of its fixed telephony services. For each application, PCCW-HKT must submit the relevant cost information for the TA to carry out a profitability analysis and to conclude whether there is any prohibited pricing behaviour. The purpose of such close scrutiny is to ensure that PCCW-HKT would not abuse its market powers to engage in anti-competitive behaviour. For example, tariffs below costs could be predatory pricing strategy to drive out competition. The TA must approve or reject any tariff revision within 30 days and tariff for new services within 45 days upon receipt of the application. PCCW-HKT must also publish its individual tariff plans in the Government Gazette before such tariffs become effective. In 2003, the TA approved 58 out of 66 fixed telephony tariff applications filed by PCCW-HKT. The average time taken was 17 days for tariff revision and 25 days for new services.

Ex ante vs ex post regulation

10. In principle, regulatory intervention is only a 'remedy' in the absence of effective competition in the market. Such remedial measures should be 'proportionate' to the state of competition in the market. Looking forward, it may no longer be proportionate to subject PCCW-HKT's pricing of fixed telephony services to the TA's prior approval. Accordingly, the TA proposes the possible modernisation of the regulation over PCCW-HKT from *ex ante* to *ex post*.

11. In the transition from a legacy monopoly structure, where the incumbent has discretionary market power, it is desirable to have pre-emptive, *ex ante* regulation to protect the development of new competition. This is because the risks of strategic behaviour by the

incumbent might otherwise dissuade new parties from entering the market at all. As telecommunications markets continue to develop, *ex ante* regulation of an incumbent should be progressively scaled back into *ex post*.

International best practice

12. The OFTA's proposal would also reflect international best practice. In the United Kingdom, the *ex ante* conditions imposed by the Office of Communications (Ofcom) in November 2003 on British Telecom (BT), found to have significant market power in the 'fixed narrowband retail services markets', did not include a requirement for BT to obtain prior approval from Ofcom of its tariffs. The 'remedies' imposed on BT include price cap, no undue discrimination, price publication and notification to Ofcom, and accounting separation. In Australia, *ex ante* regulation was replaced by *ex post* in 1997 when the market was fully liberalised, even though Telstra was still dominant in the market at the time. Under the regulation, Telstra is required to file tariffs with Australian Competition and Consumer Commission (ACCC), who may publish the filed tariffs if benefits to public outweigh detriments due to lessening of competition and prejudice to commercial interest. Prior approval of the tariffs from ACCC is not a requirement under the *ex post* regulation.

The existing licensing regime: 'all-or-nothing' approach

13. Bound by its existing licence, PCCW-HKT is subject to *ex ante* regulation unless and until the TA forms an opinion that it is not dominant. On the other hand, the TA cannot waive any of the *ex ante* tariff obligations without a positive finding of non-dominance. This 'all-or-nothing' approach is inconsistent with the principles that the level of regulation should be proportionate and commensurate with market conditions.

14. Maintaining *ex post* safeguards intact is crucial for the long-term success of telecommunications deregulation in Hong Kong. OFTA is concerned that a positive opinion of non-dominance could, in a way not anticipated in 1995 when PCCW-HKT's licence was prepared, block or prejudice any subsequent application of section 7L of the Telecommunications Ordinance (the Ordinance) against any abusive conduct of PCCW-HKT in the future. This forms the basis of the proposed alternative approach which will remove any legal uncertainty.

Consumer protection under *ex post* regulation

15. Under *ex post* regulation, the Telecommunications Ordinance provides consumers with proper protection against anti-competitive practices of telecommunications licensees.

16. First, section 7K(1) of the Ordinance provides that a licensee shall not engage in conduct which, in the opinion of TA, has the purpose or effect of preventing or substantially restricting competition in a telecommunications market. Second, section 7L(1) of the Ordinance provides that a licensee in a dominant position in a telecommunications market shall not abuse its position. Third, under section 7N(1) of the Ordinance, a licensee who is in a dominant position in a telecommunications market shall not discriminate between persons who acquire the services in the market on charges or the conditions of supply, subject to the conditions that TA is of the opinion that such discrimination has the purpose or effect of preventing or substantially restricting competition in a telecommunications market, and that there is no prejudice to the operation of section 7K.

17. As such, any anti-competitive conduct in relation to the provision of telecommunications services by licensees, including but not limited to PCCW-HKT, will always be subject to *ex post* regulation. Choices of and protection on consumers will not be compromised as a result of the adoption of our proposal.

Licence replacement

18. Under the Telecommunications (Carrier Licences) Regulation⁴, an existing FTNS licensee is entitled to surrender its existing FTNS licence⁵ in exchange for the TA issuing an FC licence⁶. Should PCCW-HKT surrender its existing FTNS licence in exchange for the new FC licence under consideration, the opportunity would arise for the provisions in relation to tariff regulation to be modified while avoiding the legal risk associated to a positive finding of non-dominance. This approach would represent an important change to the existing licensing regime and could not be implemented without:

⁴ Made under section 7(2) of the Ordinance

⁵ Regulation 4(3) of the Carrier Regulation

⁶ Section 7(5) of the Ordinance

- (a) the consent of PCCW-HKT on the replacement FC licence and the surrender of its existing FTNS licence; and
- (b) consultation of the public and affected parties pursuant to section 6C of the Ordinance.

Proposed changes in licence conditions

19. In summary, the draft FC licence differs from PCCW-HKT's existing licence in the following ways:

- (a) Prior approval of tariffs and price promotions by the TA will no longer be required. However, any anti-competitive conduct will be subject to financial penalties and third-party damages under the Ordinance.
- (b) PCCW-HKT must publish its standard tariffs, and notify the TA of any discount to its published tariffs seven days before the discount becomes effective, so that any anti-competitive conduct may be detected in a prompt and efficient manner.
- (c) The TA will have the discretion to publish any discount notified by PCCW-HKT where consumer interest so justifies, such as residential telephony charges.
- (d) Licence conditions that are redundant to the Ordinance (because the corresponding provisions have now been incorporated into the Ordinance pursuant to the 2000 amendments) are removed.
- (e) Licence conditions which refer to the test of dominance are removed. There will no longer be any presumption of dominance or non-dominance.
- (f) PCCW-HKT will be required to practise 'current cost' accounting and furnish such information upon request by the TA to facilitate any investigation under the *ex post* regulatory regime.

Office of the Telecommunications Authority
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