Consultation Paper on
Review of the Regulatory Framework for Universal Service Arrangements

Executive Summary

S1. The present regulatory framework for universal service obligation (**USO**) was established by the Telecommunications Authority (**TA**) in 1998 and subsequently updated in 2000. PCCW-HKT Telephone Ltd. (**PCCW-HKTC**) is the only universal service provider (USP), charged with the USO to provide "basic service" which consists essentially of telephone line service and public payphone service.

S2. PCCW-HKTC is compensated under the Universal Service Contribution (**USC**) scheme for the net cost it incurred in meeting the USO. Currently, carriers and service providers providing external telecommunications services, essentially IDD services, are required to pay USC on the basis of external traffic minutes handled by them.

S3. With the rapid change of the telecommunications market since 2000, including increase in competition between network operators, decline in IDD profitability, and emergence of new technologies such as VoIP, the existing regulatory framework is fast becoming outdated. The TA therefore issues this consultation paper to review comprehensively the universal service arrangements and invites comments from the industry on the following areas:

- Universal service arrangements
- Scope of universal service;
- Competitive provision of universal service;
- Exclusion of areas with alternative fixed network coverage from the USO ;
- Costing for USO;
- Funding arrangements for USO; and
- Administration matters

Universal Service Arrangements

S4. The existing objectives for the universal service are i) to ensure access to affordable basic telephone services for all people in Hong Kong on a non-discriminatory basis irrespective of where they reside or carry on business; and ii) to ensure that the costs of providing universal basic services are fairly borne by the users of network services. The TA is of the preliminary view that generally the universal service arrangements should continue to be maintained.

Scope of Universal Service

S5. The scope of universal service is the "basic service" defined in section 2 of the Telecommunications Ordinance. The telephone line service as part of the universal service supports voice telephone and narrowband internet access up to 56 kbps. The TA takes a preliminary view that the current scope of universal service, other than directory enquiry service and weather warning services, should be maintained.

Competitive Provision of Universal Service

S6. Under the existing legislation, the obligation to provide universal service can only be imposed on fixed carrier licensees. Under existing licence conditions, the obligation is imposed only on the incumbent local fixed carrier licensee, PCCW-HKTC. The existing legislation and licence conditions therefore have incorporated a historical bias in favour of using technologies for fixed services to fulfil the universal service obligation. The TA seeks the view of the industry as to whether competition should be introduced to the universal service arrangements such that the service should be provided by the operator using the technology that can provide the service in the most efficient manner.

Exclusion of areas with alternative fixed network coverage from the USO

S7. As competition develops, the very reason for designating a USP may disappear. The TA is of the preliminary view that areas or buildings with alternative fixed network coverage should be excluded from the USO. Similarly, uneconomic payphones in the vicinity of locations where competitive or alternative service is offered should be excluded from the USO scheme.

Costing for USO

Relevant Revenue and Cost under Competition

S8. PCCW-HKTC has made numerous promotional offers as competition intensifies. To ensure that the universal service contributors are not unfairly financing the marketing campaigns of PCCW-HKTC, any discounts including, but not limited to rebates, waivers, allowances and freebies associated with the promotional programs are excluded from the USC calculation. After these adjustments, those telephone lines under promotions by PCCW-HKTC that are still uneconomical but could have been switched to other competitors had those promotions not existed would be totally excluded from the USC calculation. The TA seeks the view of the industry as to whether or not the treatment of telephone lines under promotions as stated above should continue to be applied.

Costing Principles

S9. The existing costing principles are based on historical cost and the number of lines in service. These suffer certain drawbacks as market circumstances have changed. For example, "asset written downs" that are sunk costs irrelevant to the pricing decision and the excess capacity cost that does not contribute to the generation of relevant revenue are at present included in the USC calculation. The TA seeks the view of the industry whether or not these costs should be excluded. The industry is also consulted on alternative costing principles such as "forward-looking current cost" approach for USC calculation.

The Aggregation Basis

S10. At present, the net cost of USO is computed on a "customer-by-customer" basis. However, operators typically make their investment decisions for network rollout on a "cluster" or "area" basis, rather than on a per-customer basis. The proposal of aggregation on the basis of "area" is put forth in the consultation paper. For purpose of calculating USC, the practical choice is either on an "exchange area" basis or on a "distribution point" basis as the existing PCCW-HKTC's accounting systems can readily capture the relevant data.

Other issues

S11. The TA also consult the industry on the intrinsic benefits of being a USP, the replacement of the modelling approach with trend analysis, and the implications of over-compensation in Local Access Charge on USC level.

Funding Arrangements for USO

S12. With the legacy of cross-subsidy between local and IDD services being rectified and that the profit margins generated by external services are on the decline, together with the advent of Internet Protocol Telephony provided over broadband connections, there is a need to review the USC sharing mechanism by considering alternative sharing basis such as eligible revenue generated and telephone numbers allocated.

S13. The TA has identified four options of USC sharing basis for consultation, namely:

> Option 1 – *Status quo*, i.e. sharing on the basis of IDD traffic minutes through circuit-switched networks;
> Option 2 – Sharing on the basis of eligible revenue;
> Option 3 – Sharing on the basis of numbers allocated to fixed services with prefixes 2, 3, 8, 57 and 58; and
> Option 4 – Sharing on the basis of numbers allocated for fixed and mobile services with prefixes 2, 3, 6, 8, 9, 57 and 58 when mobile network operators are treated the same as fixed network operators in relation to fixed-mobile interconnection regulation, subject to the outcome of consultation of the Deregulation for Fixed-Mobile Convergence. Prior to that Option 3 is adopted.

Administration Matters

S14. The TA seeks the view of the industry on the existing USC collection mechanism through an intermediary. In addition, he proposes that the accumulated unclaimed USC rebate to universal service contributors (approximately $5 million) should be used to reduce the level of the USC.

Implementation of the New Regime in Phases

S15. The TA proposes to divide the review into two phases. "Relevant Revenue and Cost under Competition", "Exclusion of areas with alternative fixed network coverage from the USO", "The Aggregation Basis" and "Funding arrangements for USO" will be covered in Phase 1. This phase may include other issues after consulting with the industry.

Office of the Telecommunications Authority
28 December 2006

Press Release

OFTA Reviews the Universal Service Obligation Arrangements

The Office of the Telecommunications Authority (OFTA) issued today (28 December 2006) a consultation paper to solicit views from the public and the industry on its proposal of reviewing the universal service obligation (USO) arrangements.

The purpose of the USO is to ensure that basic service, which consists essentially of telephone line service and public payphone service, is available and affordable to all people in Hong Kong on a non-discriminatory basis irrespective of where they live or do business. PCCW-HKT Telephone Ltd. (PCCW-HKTC) is currently the only service provider being charged with the obligation to provide universal service in the territory.

Under the USO scheme, PCCW-HKTC is compensated for the net cost that it has to incur for providing services to unprofitable customers and public payphones. The net cost is shared by all licensees who provide external telecommunications service (ETS), commonly known as IDD service, based on the traffic volume which the individual licensee handles.

"The present USO regulatory framework has been in place since 1998. Although it was updated in 2000, the telecommunications market has since then experienced rapid changes, such as more households being served by alternative network operators, declining profits in the IDD service and emergence of new technologies such as voice over Internet protocol (VoIP). In view of the fast-changing telecommunications landscape, the existing USO regulatory framework may not be sustainable in its present form. There is therefore a need to review the regulatory framework to ensure that it may keep pace with the market and technological developments," a spokesperson of OFTA said.

"At present, 76% of households have already had alternative local fixed network operators serving their buildings. All local fixed network operators also provide ETS and therefore need to bear the costs of PCCW-HKTC serving unprofitable customers. We have to examine whether alternative fixed network operators should continue to subsidise the costs incurred by PCCW-HKTC in serving unprofitable customers when the operators themselves are able and willing to serve these customers without subsidisation. As such, we would like to seek the views of the public and the industry on the proposed exclusion from the USO scheme of areas or buildings with alternative fixed network coverage," the spokesperson added.

"The profit margin of ETS operators has been significantly driven down by the intensive competition since the liberalization of the ETS market in 1999. The advent of VoIP technology and broadband network access has also made possible the provision of international voice service outside the traditional public switched telephone network. We therefore see also the need to review the current sharing mechanism and explore other alternatives in order that we may put in place a fair, sustainable and effective arrangement," elaborated the spokesperson.

Other issues identified in the consultation paper include the scope of the universal service, how the cost for the USO should be assessed and whether competition should be introduced for the provision of the universal service.

Interested parties are invited to submit their comments on the consultation paper on or before 28 February 2007 . The paper can be downloaded from OFTA's website at www.ofta.gov.hk.

Background

- The present universal service obligation regulatory framework was established by the Telecommunications Authority in 1998 and subsequently updated in 2000. Its policy objectives are:

    a. To ensure access to affordable basic telephone services for all people in Hong Kong on a non-discriminatory basis irrespective of where they reside or carry on business;
    b. To ensure that the costs of providing universal basic services are fairly borne by the users of network services.

- PCCW-HKTC is compensated under the USO scheme for the net cost that it has to incur for serving unprofitable customers under the USO. The amount of universal service contribution for 2004 was $103.3 million.

Office of the Telecommunications Authority
28 December 2006