For discussion **FCR(97-98)99**
on 27 February 1998

ITEM FOR FINANCE COMMITTEE

HEAD 106 - MISCELLANEOUS SERVICES
New Capital Account Subhead "Cash compensation for early termination of exclusive telecommunications licence"

Members are invited to approve a new commitment of $6.7 billion for payment of cash compensation to Hong Kong Telecom International Limited for the early surrender of the exclusive telecommunications licence.

PROBLEM

We need to make cash compensation to Hong Kong Telecom International Limited (HKTI) as part of the agreement with its parent company Hong Kong Telecommunications Limited (HKT) for surrender of the exclusive telecommunications licence granted to HKTI ahead of the expiry of the licence in 2006.

PROPOSAL

2. The Secretary for Economic Services proposes to create a new commitment of $6.7 billion for cash compensation to HKTI for early surrender of the exclusive telecommunications licence granted to it under the Telecommunication Ordinance.

/JUSTIFICATION .....

JUSTIFICATION

3. Government granted HKTI a licence under the Telecommunication Ordinance (Cap. 106) in 1981, which provides it with exclusive rights for certain external circuits and telephone services. The licence is not due to expire until 30 September 2006. These exclusivities are out of line with the best current international practices and have adverse implications on our regional competitiveness both in telecommunications and services generally. With these considerations in mind, Government has negotiated and signed with HKT, the parent company of HKTI, an Agreement[(a)] which will, subject to Members' approval of certain aspects of it, result in the early surrender of the HKTI licence. For the Agreement to become operative, a condition precedent is that the appropriation procedures for compensation, with an after tax value to HKTI of $6.7 billion, are completed. After satisfaction of all the conditions precedent set out in the Agreement, HKTI will surrender its licence on 31 March 1998 in return for two equal payments of $3.35 billion, the first on 31 March 1998 and the second on 1 July 1998.

Further Liberalisation

4. The HKTI licence contains exclusive rights valuable to the company. We have liberalised international telecommunications services as much as we can within the constraints posed by the licence. We have permitted call-back services, virtual private networks and International Simple Resale (ISR) of facsimile and data. But the exclusivities over the core IDD services and public circuits remain. For routes over which call-back is not permitted (including those to the Mainland, which comprise 49.8% of all external traffic) competition is very limited and consumer prices have not reduced significantly. On call-back routes HKTI has benefited, despite the additional competition, from the carriage of the additional traffic which call-back has generated. The HKTI licence is a distortion in the Hong Kong telecommunications market, and deprives consumers (residential and business alike) of choice and price reductions. It reduces the opportunities of telecommunications providers to offer alternative products and full service, and harms Hong Kong's overall competitiveness through higher prices and lack of choice.

/**Agreement** .....

Encl. 1

(a) Full text of the Agreement is at Annex A to the Provisional Legislative Council Brief "Resolution of the Licence of Hong Kong Telecom International Limited" issued on 20 January 1998, now reproduced at Enclosure 1.

Agreement with HKT

5. In the conditions which apply in the Asia-Pacific region today, the HKTI licence is an unnecessary barrier to Hong Kong's competitiveness. As a matter of policy the Government does not renege on licences which it has granted as to do so would create an unacceptable precedent and undesirable uncertainties for holders of any Government licence issued. To resolve the HKTI licence satisfactorily, we negotiated with HKT the early surrender of the HKTI licence on a "willing buyer, willing seller" basis. These negotiations have resulted in the Agreement which was executed by both parties on 20 January 1998. The essential components of the Agreement are as follows -

(a) HKT will surrender the HKTI licence on 31 March 1998 with external services-based competition beginning on 1 January 1999 and external facilities-based competition beginning on 1 January 2000 (at which date the last remaining exclusivities in telecommunications will expire);

(b) the Telecommunications Authority will amend the Fixed Telecommunication Networks Services (FTNS) licence given to the Hong Kong Telephone Company (HKTC), also a subsidiary of HKT, to encompass external telecommunications services and circuits, and lift the structural separation hitherto enforced on HKTC and HKTI;

(c) subject to approval of the Provisional Legislative Council (PLC), the statutory price control arrangements for HKTC through the Telephone Regulation will be lifted, and in its place HKTC will be permitted a phased increase in the ceiling on residential exchange line tariffs (subject to improved market contestibility and market discipline in prices), increases in business exchange line tariffs (subject to market pressure) and to maintain (subject to a review in early 2000) the CPI(A) - 4% cap on the other services currently so restricted[b]; and

(d) subject to Finance Committee's approval, Government will pay HKTI cash compensation of $6.7 billion net of tax in two equal tranches on 31 March and 1 July 1998.

/The .....

---

[b] Details are set out in PLC Brief, "Telephone Ordinance (Chapter 269) Telephone (Repeal) Regulation 1998" issued on 6 February 1998, now reproduced at Enclosure 2.

Encl. 2

The Financial Model

6. In order to assess fairly the financial impact on HKT of the early surrender of the HKTI licence and to estimate the corresponding tangible benefits, the Government constructed, with the assistance of a consulting firm, a financial model of the fixed external and internal telecommunications market in Hong Kong. The model[c] establishes a "base case" which assumes the development of the telecommunications markets without the surrender of the HKTI licence until 2006. It takes into account the continuing impacts of the liberalisation which do not break HKTI's exclusivities (call-back, ISR of facsimile and data, etc.) and considers international developments in accounting rates and natural market expansion. The cumulative Net Present Value (NPV) of the net cash flow of HKTI and HKTC is then calculated until 2006.

7. The financial model constructs, in parallel, a "liberalisation case" which does the same for the liberalised market. It adjusts for price changes in the market and stimulation in the market as lower prices increase demand. It also considers redistribution of traffic among the competitive operators and the different forms of services. For instance, from costing data it is clear that ISR of voice will be cheaper, and of better quality, than call-back services. The price of call-back services will rise as the current below-cost contracts between Hong Kong and overseas operators fall to be renegotiated. The model, therefore, migrates call-back customers to ISR on the routes where this is allowed.

8. The model also takes account of market share loss by HKTC as more customers switch to other FTNS operators which would also provide full external service products, and as the accelerated opening up of HKTC's existing local access network to its competitors under the Agreement starts to take effect. From the model we estimate the net reduction in HKT's cashflow of the "liberalisation case" over the "base case". Similarly from the model we obtain the net savings in consumer payments. Sensitivity tests have been conducted on the model and the results show the financial impact on HKT will be in the range $12 billion to $20 billion (NPV). The most probable level of the impact on HKT is towards the middle of the range.

Economic benefits

9. The tangible economic benefits which we estimate will result from this Agreement amount to $17.1 billion (NPV) comprising $14.8 billion (NPV) in

/IDD.....

Encl. 3 [c] Details are set out in the PLC Supplementary Brief "Surrender of the HKTI Licence, Financial Modelling and Fair Competition" issued on 27 January 1998, now reproduced at Enclosure 3.

IDD reductions and $2.3 billion (NPV) in leased circuit reductions. Given our estimate of the size of the external services market in the base case to 2006 of $106 billion (NPV), the reductions posited are of the order of 16%. These are conservative figures and, given the actual costs involved (e.g. ISR based services would give comparable profit margins to call-back services even at a lower price to the consumer) we may well see greater tangible benefits than we are estimating.

10. We estimate there will be considerable intangible economic benefits arising from the Agreement, and that these are likely to exceed the tangible benefits in their value for Hong Kong's future prosperity. Key intangible benefits include -

(a) *Greater consumer benefits*

Flowing from competition in terms of increased choice, new services, innovation, etc.

(b) *Increased competitiveness for the Hong Kong economy*

A wider variety of more efficient telecommunications services will benefit Hong Kong's entire services sector as this is underpinned by telecommunications.

(c) *Increased attraction for Hong Kong as a telecommunications hub and regional business location*

Telecommunications figures highly in business decisions about the location of regional headquarters. Improving telecommunications will favour Hong Kong in taking such decisions.

(d) *New investment and new employment*

The Agreement will give rise to considerable further investment in telecommunications. Already we are seeing announcements of such investments (see paragraph 11 below). The additional regional headquarters will also generate investments and jobs outside the telecommunications sector.

(e) *Positioning Hong Kong as an Information Society*

Government's vision is to make Hong Kong a leader not a follower in the Information Age. To meet this objective, we need to maximise our Information Infrastructure to ensure it is economically

/efficient .....

efficient. The Agreement provides the right environment for this. It is this intangible benefit which could prove to be the greatest single bonus to Hong Kong of the Agreement.

11. It is our view that the Agreement is a good deal for Hong Kong and is a major step forward in transforming and stimulating our economy as it moves to meet the challenges of the Information Age. For this we need diversity of telecommunication suppliers, products and routes. Already we are seeing, in anticipation of the approvals necessary for the Agreement to go forward, movements to make the necessary large-scale investments. One FTNS operator has recently announced its forecast investments of $8 billion and the creation of 1 000 jobs directly (and at least that number indirectly) as a result of the Agreement to surrender the HKTI licence early.

Compensation Package

12. There are three elements to the compensation package within the Agreement. These are -

(a) C*ash compensation*

$6.7 billion net of tax to HKTI

(b) *Waiving of royalty from 20 January 1998*

The waiving of royalty will mean revenue forgone of around $3.1 billion (NPV) on the part of Government. This is the amount HKTI would have paid had it retained its exclusivities until 2006. In a liberalised environment, this revenue forgone is partitioned between the competitive external telecommunication providers in proportion to their share of external revenue. As we are forecasting that HKT's market share in a competitive market would fall well below 50%, HKT's share of the revenue forgone and hence the compensatory amount will be far less than $3.1 billion (NPV).

(c) *Rebalancing of local residential exchange line tariffs (in return for accelerating the opening up of the HKTC network to greater competition)*

HKT will be subject to price caps on the pace of rebalancing as set out in the Agreement. The Agreement requires the HKTC network

/to .....

to be opened up to its competitors such that at least 50% of residential exchange lines are available to them by 1 January 1999. With greater competition as its competitors gain access to more exchange lines HKT will face substantial competitive disciplines in trying to increase prices up to the price caps. Even if HKT could price up to the price caps the maximum impact on consumers of rebalancing is estimated at $3.4 billion (NPV). Not all of this impact would accrue to HKT as its competitors would gain a significant amount in proportion to their market share and tariffs. The Agreement, taken together with the regulatory obligations, provides considerable consumer protection in the event of increases in local exchange line tariffs. For example, the existing flat rate local charging system is locked in place and HKTI will not be able to discriminate in its charges between those consumers with a choice of residential line supplier and those without choice.

13. The total cost to the community of the Agreement is a maximum of $13.2 billion, well below the tangible consumer benefits of $17.1 billion (NPV). HKT will not be able to realise all of this as some will accrue to its competitors. We estimate the amount HKT will realise in compensation will not exceed the lower bound of our valuation range for the licence of $12 billion to $20 billion (NPV).

14. The foregoing has demonstrated that the Agreement reached with HKT is a reasonable one and a good deal for Hong Kong. The sum of $6.7 billion to compensate HKTI is an essential component as it will enable us to obtain an early surrender of the HKTI licence and allow us to license competitors in sufficient time to have effective competition starting from 1 January 1999. The total compensation package for HKT is only about 6% of HKT's market capitalisation despite the fact that HKTI accounts for more than 30% of HKT's annual profit after tax ($3.7 billion out of $11.2 billion in 1996-97). The amount of cash compensation was arrived at after consideration of the financial models and through negotiations. As such it is part of an overall package for the resolution of the HKTI licence. If any one part of the package fails then the whole Agreement fails. If the whole Agreement fails, the HKTI licence with its exclusivities will remain in place until 30 September 2006. Consumers will be paying an additional $17.1 billion (NPV) for the external services, with no choice on a number of routes, less choice on the other routes and a reduced choice of technology. Non-surrender of the HKTI licence would bring reduction in Hong Kong's competitiveness, less investment and fewer quality job opportunities as Hong Kong falls to the back of the pack in the race to become the premier telecommunications hub and leader of the Information Age in the Asia Pacific

/region .....

region. Benefits of such failure will be small to consumers - royalty payments will resume and there may be some delay in increasing local exchange line rentals towards cost, but the latter is inevitable as it is not realistic to expect the below-cost environment to be sustainable. There will be no benefits to telecommunications companies except possibly the HKT group.

15. All in all, we now have a unique opportunity to liberalise the last monopoly in Hong Kong's telecommunications. Significant benefits will flow from the Agreement.

FINANCIAL IMPLICATIONS

16. We propose the creation of a non-recurrent commitment of $6.7 billion to meet the cash compensation payment. The Commissioner for Inland Revenue has advised that the exclusive telecommunications licence to HKTI is regarded as a capital asset of the company, and compensation to be payable to it by Government for the early surrender of the licence is of a capital nature which is not chargeable to profits tax under the Inland Revenue Ordinance. The question of grossing up the commitment to ensure receipt of $6.7 billion net of tax by the HKTI therefore does not arise.

17. Subject to Members' approval of this proposal, we will pay the compensation to HKTI in two equal instalments of $3.35 billion on 31 March 1998 and 1 July 1998 through supplementary provision under delegated authority.

BACKGROUND INFORMATION

18. The background to the Agreement is given in Enclosures 1 to 3. We briefed the PLC Economic Services and Information Policy Panels at a joint meeting on 9 February 1998.

Economic Services Bureau
February 1998

Enclosure 1

PROVISIONAL LEGISLATIVE COUNCIL BRIEF

The Secretary for Economic Services submits the following note for Members' information -

Title of Note	Date of ExCo
Resolution of the Licence of Hong Kong Telecom International Limited; Telecommunication Ordinance (Chapter 106) - Amendment of the Licence of Hong Kong Telecom International Limited; Telecommunication (Amendment) Regulation 1998	20 January 1998

20 January 1998

Economic Services Bureau

Secretariat's note

Annexes A to E not attached. Members who wish to obtain a copy, please contact Ms Sharon CHAN at 2525 4327.

File Ref. : ESBCR 9/1056/93(98)

PROVISIONAL LEGISLATIVE COUNCIL BRIEF

RESOLUTION OF THE LICENCE OF HONG KONG TELECOM INTERNATIONAL LIMITED

Telecommunication Ordinance (Cap. 106)
AMENDMENT OF THE LICENCE OF HONG KONG TELECOM INTERNATIONAL LIMITED

TELECOMMUNICATION (AMENDMENT) REGULATION 1998

INTRODUCTION

Hong Kong Telecom International Limited (HKTI) possesses a licence, with exclusive rights for certain external circuits and telephone services, which is due to expire on 30 September 2006. These exclusivities are out of line with best current international practices and have adverse implications for our regional competitiveness in telecommunications and, as telecommunications underpin the vital services sector of the economy, the exclusivities have negative impacts for Hong Kong's competitiveness as a whole. With these considerations in mind the Government has been negotiating with Hong Kong Telecommunications Limited (HKT), the parent company of HKTI, for an early surrender of the HKTI licence. The negotiations have resulted in an agreement with HKT under which HKTI would relinquish its exclusivities.

2. At the meeting of the Executive Council on 20 January 1998, the Council ADVISED and the Chief Executive ORDERED that:

(a) the terms and conditions under which HKTI would surrender its licence be accepted, subject to the necessary approvals of the Provisional Legislative Council. These terms and conditions are set out in the Agreement at Annex A and can be summarised as :

A

(i) HKT would surrender the HKTI licence on 31 March 1998 with external service based competition beginning on 1 January 1999 and external facilities based competition beginning on 1 January 2000;

(ii) the FTNS licence given to the Hong Kong Telephone Company Limited (HKTC), a subsidiary of HKT, be amended by the Telecommunications Authority (TA) to encompass external services and circuits, and the structural separation enforced on HKTC and HKTI would be lifted;

(iii) royalty payable by HKTI on its exclusivities would cease on 20 January 1998;

(iv) the statutory price control arrangements in place on HKTC through the Telephone Regulation would be lifted, and in place HKTC would be permitted a phased increase in its residential exchange line tariffs (subject to improved market contestibility), increases in business exchange line tariffs (subject to competitive pressure) and would maintain (subject to a review in early 2000) the CPI(A)-4% cap on the other services currently so restricted; and

(v) subject to the provision of the necessary funds by Finance Committee of the Provisional Legislative Council, compensation of \$6.7 billion (net of tax) would be paid in two equal instalments on 31 March and 1 July 1998, respectively;

B (b) the Secretary for Economic Services should be authorized as at Annex B to sign the Framework Agreement; (not attached)

C (c) the HKTI licence be amended as at Annex C to effect the cessation of royalty;

D (d) the Telecommunication (Amendment) Regulation at Annex D should be made under section 34 of the Telecommunication Ordinance; and (not attached)

E (e) the Policy Statement "Liberalisation of Hong Kong's External Telecommunications" at Annex E should be noted.

BACKGROUND AND ARGUMENT

Telecommunications in Hong Kong

3. Over recent years Hong Kong has become one of the world's most advanced and liberalised telecommunications markets. The HKTI exclusivities on certain external telecommunications services and facilities, comprising about one third of total telecommunications revenues, remains an exception to this picture of liberalisation. These exclusivities were granted in 1981, when a monopoly paradigm for telecommunications services and facilities was the norm, and they are not due to expire until 30 September 2006. The continued existence of these exclusivities will hinder the Government's telecommunications objectives of ensuring the widest range of quality telecommunications services should be available at reasonable cost, maximising economic efficiency in the industry and of maintaining Hong Kong's position as the pre-eminent telecommunications hub in the Asia Pacific region.

4. Since telecommunications plays a vital role in the development of industry, finance and commerce and underpins the increasingly important information industries, hindrances to the development of telecommunications will also hinder Hong Kong's competitiveness in these other areas. Our regional competitors either already have advanced, totally liberalised telecommunications regimes (Australia, Japan, New Zealand) or have already announced such plans to liberalise (Singapore from April 2000). Other less developed countries in the region already have licensed competitive external telecommunications operators (the Philippines, Malaysia and Indonesia). We cannot afford to be left behind in the developing Information Age.

5. We are seeing already the benefits of competition in the local mobile telecommunications sector and increasingly in the local fixed telecommunications sector. In our view providing a fair environment in which competition in the external telecommunications market can flourish and meet customers' choices is one of the key means of enhancing Hong Kong's competitiveness both in telecommunications and the service sector generally. The quality, price and choice of telecommunications services are significant factors in decisions on business locations.

6. There are additional reasons for wishing to resolve early the exclusivities in the HKTI licence. Set against today's technologies and particularly the technologies of tomorrow, e.g. the 'Internet phone', there

are ambiguities in HKTI's exclusivities; there are also outstanding differences of interpretation of the licence between the Government and the company. While these differences may be capable of resolution in a piece-meal manner, with uncertain outcome, there would be considerable litigation risks plus attendant costs and such an approach would not provide a stable environment conducive for the vital investment needed in our emerging information infrastructure.

7. These problems of boundary distinctions of the exclusivities and uncertain investment climate impact on both the Government and HKT. They impact also on all telecommunications players in Hong Kong because the distortions arising from the HKTI licence permeate the entire industry. To help resolve these problems and in recognition, we believe, of the world-wide trend towards liberalisation from which HKT and Cable and Wireless plc (C&W) (the majority (54%) shareholder of HKT) can benefit, HKT agreed in June 1996 to discuss the early resolution of the HKTI licence. After many rounds of negotiations, agreement has been reached with HKT.

<u>The Agreement in Summary</u>

8. The Agreement is complex as it involves many interlocking steps which are explained in later paragraphs of this Brief as well as in the annexed Policy Statement. In summary:

- The Agreement is to be executed on 20 January 1998 - on this date HKTI stops payment of royalty.

- HKT surrenders the HKTI licence on 31 March 1998 subject to several conditions precedent - in particular, that the Finance Committee agrees to the payment of cash compensation of $6.7B (net of tax) and the Regulation making the price control arrangement on HKTC is terminated.

- On surrender of the HKTI licence on 31 March 1998 the Government pays HKT half of the cash compensation (i.e. $3.35B net of tax).

- On 1 July 1998 the Government pays the remaining cash compensation (i.e. $3.35B net of tax).

- Competition on external services starts on 1 January 1999.

- Also on 1 January 1999 HKTC can raise its local residential line charges subject to having opened up its local network to greater competition.

- On 1 January 2000 competition on external circuits and facilities commences. This represents the complete end of the HKTI exclusivities.

The Liberalised External Telecommunications Market

9. On telecommunications policy grounds to achieve the maximum consumer benefit, to give real opportunities for competitive telecommunications investment, to improve services in both price and quality and to eliminate the distortions caused by the HKTI licence, we have been able to reach agreement with HKT to liberalise all the remaining exclusivities in the HKTI licence. Having taken into account consumer benefit; the time required for new entrants to the external telecommunications and facilities services markets to make the necessary investments, negotiate interconnection arrangements and provision external circuits; and the net present value of the remaining exclusivities and the compensation payable, we have negotiated with HKTI a phased approach to liberalisation such that :

(a) external telecommunications services competition would begin on 1 January 1999;

    [This would allow, for instance, International Simple Resale of voice services by licensed providers over capacity leased from HKTI and would be technically superior to, and more sustainable than, call-back]; and

(b) external telecommunications facilities-based competition would begin on 1 January 2000.

    [This would allow relevant licensed service providers to provide services over their own facilities (cable systems, satellite stations etc)]

10. HKT has agreed that the HKTI licence will be surrendered on 31 March 1998 and that, henceforth, the services and circuits would be provided under the fixed telecommunications network services (FTNS) licence issued to HKTC, but amended to extend its scope to cover external fixed telecommunications services and circuits, and to be issued in the names of Hong Kong Telecom CAS Limited (HKTCAS), HKTI and

HKTC. This will enable the services and circuits currently within the HKTI licence to be regulated on a fair competition basis - something which is not possible with the monopoly-model HKTI licence. We intend that the other three FTNS licensees (Hutchison Communications, New T&T and New World Telephone) would be invited to submit their FTNS licences so that they may be amended to permit the supply of non-exclusive external services from 1 January 1999 and non-exclusive external facilities from 1 January 2000. A new non-exclusive external services licence would also be available for non-FTNS telecommunications operators from 1 January 1999. Whether there would be additional telecommunications facilities operators is an issue that we will revisit in the context of the committed 1998 FTNS review.

11. The agreement to terminate the HKTI exclusivities has required us to review in parallel the issues of policy and regulation that arise in a competitive external services market. The Policy Statement "Liberalisation of Hong Kong's External Telecommunication" at paragraphs 12 - 32 of Annex E addresses the content of these issues and indicates the considered, but preliminary, views of the Government on these matters. For some of these the TA will need to initiate the necessary consultations in the coming months with a view to deciding such matters in time for the necessary business decisions to be made.

12. By licensing external telecommunications services under the FTNS form of licence we will apply the same regulatory regime to these services as applies now for the local telecommunications market. This approach will ensure consistency and that we can maintain the necessary consumer protection measures and safeguards against anti-competitive practices.

<u>Rebalancing/Removal of Price Control Arrangement</u>

13. At present the local telephone services are subsidised by about $1 billion annually by the external services - each residential telephone line costs HKTC about $103 per month to provide yet it only receives $68.90 in monthly line rental revenue. As external services become increasingly competitive, it is not possible for this subsidy to continue. Such subsidies have been common world-wide but with increasing liberalisation the economic inefficiencies resulting from these subsidies have become less tolerable. Many countries, including the Mainland, have moved to remove or reduce such subsidies, and it is clear that this is now best international practice. In addition the cross-subsidy is simply unsustainable as the international accounting rate settlements

system is undergoing dramatic reform such that no element of supra-profit will remain to fund local cross-subsidises. It is inevitable that local telephone rates will have to increase in Hong Kong whether or not we terminate early the HKTI licence. The advantage of increasing these rates at the same time as we liberalise external telecommunications services is that we would have a unique opportunity to give the community reductions in IDD (including to the Mainland) which will more than offset rises in local charges. Furthermore, for as long as HKTC continues to be required to provide local service below cost its competitors have little incentive to invest in their own local customer access networks because to do so would entail competing against a loss-making service.

14. In the agreement reached with HKT it is proposed to allow HKT to raise local exchange line tariffs progressively once external services competition begins on 1 January 1999. HKT has agreed to be subject to price caps on the residential exchange line services - this will limit the impact on consumers. It is the long term aim that the market will set these prices and our expectation is that competition will develop in terms of both price and service offerings. We have been keen to ensure greater contestibility of the local market and we have been able to reach agreement with HKT that it will open up its network so that its competitors can use HKTC's already installed local access lines. HKTC will enter into negotiations with the other FTNS licensees to give them access to at least half of the residential exchange line customers by 1 January 1999. As the revenue opportunities for the new FTNS operators increase we anticipate there will be a greater incentive for them to serve residential customers (as well as business customers) and this in the long term will benefit customers. The permitted price caps for HKT for residential exchange lines will be :

- *20 January 1998 to 1 January 1999 (expected start of external services competition)*

  - remain at $68.90 - there will be no increase as would otherwise have been the case on 1 August 1998.

- *for the next 12 months (expected to be 1.1.99 to 31.12.99)*

  - no more than $90

- *for the next 12 months (expected to be 1.1.2000 to 31.12.2000)*

  - no more than $100

- *until 31.12.2001*
  - no more than $110
- *after 1.1.2002*
  - no price cap; the competitive market will prevail

For business exchange lines, HKT will from the cessation of the price control arrangement no longer be subject to price control. In this they will be in the same position as currently held by the other FTNS operators. We anticipate competitive pressures will prevail as competition is already established in the business market and HKTC's existing rates are almost at cost. For other services currently covered by the price control arrangement, HKT has agreed to keep increases to the existing aggregate rate of CPI(A)-4% subject to a review after 1 January 2000.

15. To achieve this rebalancing and to demonstrate our commitment to reliance on market forces, we have agreed to repeal the Telephone Regulation, subject to the making of the necessary regulation by SES.

Compensation

16. The compensatory value HKT will derive from the Agreement is made up of three components : cash, royalty foregone and increases in local exchange line rental.

17. Determining the value in net present value (NPV) terms of the remaining exclusivities of the HKTI licence is a vexed issue. Both the Government and HKT have constructed valuation models based on how each sees, on a range of assumptions, the incremental changes to HKTI's revenue and expenditure streams due to liberalisation. The models are sensitive to changes in certain parameters, for example, tariff levels and market shares. We consider the negotiated amount reasonable allowing a fair resolution of the HKTI licence without protracted disputation over disputed aspects of the licence.

18. The case to enter into the Agreement with HKT is compelling based on the direct tangible benefits of the IDD reductions to all destinations (particularly those not currently benefiting from the low call-back rates, for example the Mainland), which are likely to be achieved after liberalisation. We estimate the tangible benefits at $17.1 billion

NPV. Even allowing for additional consumer payments due to increases in local tariffs by HKT and its local competitors (estimated at $3.4 billion NPV), the $6.7B cash payment and the loss of royalty to the Government (estimated at $3.1 billion NPV) the net tangible benefits would be around $4B (NPV). In addition to these net tangible benefits, there would be considerable indirect and intangible benefits (for example, increased choice, greater innovation, better market responsiveness, increased attraction for corporations to locate in Hong Kong, increased competitiveness of the Hong Kong economy, substantial new capital investment, likely increase in employment and taxable income, etc.)

19. While the cash component of $6.7B (after tax) is a negotiated amount we believe it is reasonable when considered against the net tangible and intangible benefits from concluding this Agreement and needs to be viewed against the $7.4 billion (NPV) derived by the Government from royalty from the HKTI licence since 1981 and the $10.7 billion (NPV) capital gain from the sale of the 20% of HKT stock previously held by the Government. We are satisfied that the total compensatory package to HKT is fair and is not excessive when considering that the revenues under the HKTI licence represent more than one third of HKT's total revenues yet the total compensation package is less than 7% of HKT's market capitalisation.

20. Compensation in cash was not our initial preference: we had attempted to derive sufficient compensatory value from the development of property owned by HKTC or HKTI. However, despite intense effort we could not reach agreement on the net compensatory value to be ascribed to property and this was compounded by the recent fluctuation in the property market.

Amendment of Hong Kong Telecom International Licence

21. To give effect to clause 3.1 of the Agreement that royalty will no longer be required with effect from 20 January 1998, the HKTI Licence requires immediate amendment. The amendment at Annex C is designed to achieve this for the remainder of the term of the licence. In the circumstances where the Agreement was terminated and the HKTI licence not surrendered, this amendment would be reversed as if it had never operated, thus royalty would then be required as from 20 January 1998.

Telecommunication (Amendment) Regulation

22. The amended licence to be given to HKTCAS, as set out in Schedule 1 to Annex A, is an FTNS licence. This licence only

encompasses fixed telecommunication services and networks so the aeronautical and maritime mobile services under items (h) and (i), of the HKTI Licence (at Annex E) will not be covered. To remedy this the Telecommunication (Amendment) Regulation 1998 ("the Regulation") has been drafted to provide for a new form of licence, the Public Radiocommunication Service Licence (for Services other than Land Mobile Services).

23. Upon the surrender of the HKTI licence we wish to ensure that HKT continues to provide the aeronautical and maritime mobile services that are currently in service. As the FTNS form of licence is unsuitable, and no other suitable form of licence exists, a new form of licence is required to cover these services and the Regulation has been drafted to empower the TA to issue it. The new Public Radiocommunication Service Licence (for Services other than Land Mobile Services) is modelled on the existing Public Radiocommunication Service Licence with minor exceptions. The annual fees for the new licence are set out in the Regulation as $50,000 per licence and $1,000 per land station or land earth station operated for the service. The fees have been set to cover the OFTATF's costs.

FINANCIAL AND STAFFING IMPLICATIONS

24. The financial obligation of the Agreement is to pay HKT a total of $6.7 billion, net of tax, in two equal instalments on 31 March and 1 July 1998. As the compensation of $6.7 billion is net of tax, we will ask the Finance Committee of the Provisional Legislative Council to appropriate a grossed-up sum inclusive of HKT's liability for tax but the tax portion will be withheld by Government pending Commissioner of Inland Revenue's assessment. Since the Agreement is only possible with rebalancing of local telephone tariffs, we intend to approach the Finance Committee for approval of the cash compensation only after the Telephone Regulation has been repealed.

25. As part of the compensation the Government is required to waive royalty from 20 January 1998. The total royalty foregone between now and October 2006 when the HKTI licence was due to expire is estimated at $3.1 billion (NPV). We accept that the case to impose royalty once competition starts on services (on 1 January 1999) and facilities (on 1 January 2000) is not sustainable. However, from 20 January 1998 until these dates HKTI will maintain exclusivities and royalty could still be

imposed. Never-the-less, we have agreed to forego this royalty (amounting to about 0.5 billion NPV).

26. There will be small increase in income to the Office of the Telecommunications Authority Trading Fund (OFTATF) from the fees collected for licences for additional external telecommunication services providers. Over the longer term OFTATF will also benefit from staff and financial savings from no longer having to administer the complex boundaries of the exclusivities within the HKTI licence.

ECONOMIC IMPLICATIONS

27. The liberalisation of international telecommunications will lead to lower prices and a higher volume of international telephone services. This is likely to bring about substantial economic benefits to the community of the order of $17.1 billion (NPV), although against this should be offset the $6.7B cash compensation, $3.4 billion (NPV) for the increases in exchange line rentals and the loss of royalty of $3.1 billion (NPV). In addition, the efficiency of the industry will be improved and the status of Hong Kong as a telecommunications hub in the region will be enhanced.

PUBLICITY

28. An announcement of the decision of the Executive Council would be made to the Stock Exchange of Hong Kong at lunch time on 20 January 1998. The Government would put out a press release around 1 p.m. on 20 January 1998. This will be followed by a press conference later that afternoon.

Economic Services Bureau
Government Secretariat
20 January 1998