Introduction

1. In response to the industry consultation paper entitled "Guidelines on the Principles and Methodologies for the Interconnection Charges to Mobile Virtual Network Operators ("MVNO") and Tariffs for Content or Service Providers ("CSP") by Mobile Carrier Licensees Operating in the 1.9-2.2 GHz Band ("MNO")" issued by the Telecommunications Authority ("TA") on 6 August 2004 ("Consultation Paper"), SmarTone 3G Limited ("SmarTone") would like to provide its comments as follows.

Network Capacity

2. The issue of whether "actual utilization" or "efficient capacity" should be used for the measurement of network capacity in the calculation of open network access ("ONA") charges was raised from paragraphs 44 to 48 of the Consultation Paper. There are two approaches suggested by the TA. The first one being that cost of capital will be adjusted according to whether "actual utilization" or "efficient capacity" is used (paragraph 46). The other one is to use the "actual utilization" for each year over the economic life of an asset to derive an "effective utilization factor" based on which the ONA charges are calculated (paragraph 47).

<u>SmarTone is of the view that neither approach is practical for implementation by the MNO.</u>

3 The first approach suggests that cost of capital should be adjusted upward or downward when "efficient capacity" or "actual utilization" is used respectively for the calculation of ONA charges. Although the theory suggested may be hypothetically correct, the problem is that the magnitude of the adjustment cannot be quantified objectively. SmarTone doubts whether one can establish any generally acceptable correlation between the two factors in concern. It is difficult, if not impossible, to adjust the cost of capital fairly and objectively. If this approach is adopted, the ONA charge so calculated will be distorted by an arbitrarily adjusted cost of capital.

4. The second approach in paragraph 47 of the Consultation Paper demands MNOs to bear financial losses in the initial years with the hope that such losses will be recovered in later years of the asset economic life. SmarTone opines that this approach is not commercially realistic. In order for MNO to recover such initial losses

in later years, ONA commitment made by MVNO must be of constant volume and must cover the whole economic life of MNO's assets. It is not commercially sound because any subsequent reduction in ONA volume or termination of ONA agreement by MVNO in later years without immediate equivalent ONA substitution by another MVNO will result idle capacity and, hence, cause un-recovered loss to MNO. Besides, SmarTone considers that it is impractical to project the future utilization of the assets over the economic life of the assets. Like other emerging technology, it is extremely difficult to predict an accurate take-up rate for 3G services given that no historical trend can be used for reference. It would be inaccurate to use projected "effective utilization factor" for the calculation of the ONA charges.

5. 3G is an emerging technology and obviously MNOs investing in this new business bear significant risks. As aptly pointed out in paragraph 44 of the Consultation Paper, idle capacity is rather common during the initial phase of market development. The unavoidable idle capacity in MNO's 3G network is clearly due to the start up nature of the business, which is in sharp contrast to the mature fixed line networks whereby any excess capacity is likely due to inefficiency in network design. To ensure that the ONA charges will send an accurate "build" or "buy" signal to the market, the ONA charges should reflect the cost of the idle capacity. It is unreasonable to require MNO to provide service as if the network had been fully utilized in the initial period, as it will assume all the risk on the MNO and give unfair advantages to MVNO and CSP. All parties utilizing the network, including MVNO and CSP, should be required to share the full costs of the network even though, initially, the network has idle capacity. In the long run as the 3G market develops, all parties utilizing the network will then enjoy the benefits of higher cost efficiency.

<u>To sum up, SmarTone submits that the use of MNO's actual network utilization is the only practical, reasonable and fair option for the measurement of network capacity in the calculation of ONA charges</u>.

MVNO and CSP based on different charging principles

6. Paragraph 17 of the Consultation Paper suggests that ONA charges to MVNO, tariffs to CSP and the internal transfer prices should be based on a single and consistent set of principles, regardless of whether LRAIC or FDC are to be adopted.

<u>SmarTone opines that different charging principles should apply to MVNO and CSP respectively.</u>

7. SmarTone opines that the charging principles apply to MVNO and CSP should be based on LRAIC and FDC respectively. This is consistent with the principles as stipulated in the 3G Information Memorandum and previous reports prepared by OFTA for the development of the 3G Accounting Manual.

8. SmarTone considers that the ONA charges apply to MVNO and the tariff apply to CSP should be based on different set of costing principles, such that the tariff for CSP should be based on FDC while the ONA charges for MVNO should be based on LRAIC. SmarTone notes that the Consultation Paper suggests that the difference between FDC and LRAIC would be insignificant, since a mark up for corporate overheads cost will be included in the calculation of LRAIC. SmarTone agrees with the recommendation to include corporate overheads in determining the network charges since 3G is a new business with significant risks. MNOs are entitled to receive adequate compensation from MVNOs and CSPs to recover its overheads to preserve their investment incentives. However, SmarTone is of the view that while in theory the two costing principles may be similar as suggested by the Consultation Paper, the difference between LRAIC and FDC may still be very significant when the theory is actually put into practice. For instance, it is uncertain how much corporate overhead costs would be allowed under the LRAIC approach since the level of the mark up would be ultimately determined by the TA. On the contrary, all corporate overhead costs would be taken into account under the FDC approach as these costs are inherently built into the formula.

9. CSPs, as defined in paragraph 10 of the Consultation Paper, are wholesale customers to the MNOs and MVNOs, using the services of these operators to deliver their products to customers. It follows that the charging principles for CSP should be based on published tariff. This is consistent with the approach specified in the 3G Information Memorandum that: “The current approach for regulated published tariffs is that the TA applies a tariff based on fully distributed cost” (section 2.2.6.2). This is in line with the fixed line network charging principles under which services provided by FTNS operators to value-added service providers licensed under PNETS licence are charged on the basis of FDC. SmarTone opines that the relationship between MNOs and CSPs should follow the same principle and the tariff for CSP should be calculated based on FDC.

Current Cost Accounting

10. Under paragraph 26 of the Consultation Paper, OFTA is of the preliminary view that the current cost standard should be adopted in the calculation of ONA charges.

SmarTone disagrees with the need to maintain Current Cost Accounts (CCA) for the substantiation of ONA charges. There is no known example globally of a mobile operator being required to maintain CCA for any aspect of its business.

11. SmarTone considers that OFTA has not appreciated fully the compliance burden implied by preparing CCA accounts, nor has OFTA provided any justification to show how this information will be used to assess the appropriateness of ONA charges. There is no clear correlation between the establishment of ONA charges based on LRAIC principle and the maintenance of books of accounts to support CCA. LRAIC prices are established through an offline, engineering led process on a periodic basis which can be accomplished relatively efficiently. However, CCA accounting requires a substantial investment in technology and staff representing more than doubling of the costs incurred in meeting current regulatory requirements. SmarTone considers that OFTA has underestimated the task of implementing CCA and overestimated the potential benefits that will accrue from the provision of this information, although neither issue has been satisfactorily substantiated in the Consultation Paper.

12. We are not aware of any requirement on telecom operator in other developed countries of Asia to implement CCA. Internationally the use of CCA is limited to a few fixed line operators (e.g. BT and Telstra) which are subject to detailed regulation of their capital base and for which price controls and revenue controls are in place. None of these operators is a pure mobile operator. Moreover, it is our understanding that there is currently no requirement to implement CCA for reporting under the FTNS accounting manual. The proposal in the Consultation Paper to require 3G MNOs to adopt CCA standard has therefore gone too far from the current regulatory practices applied to telecom networks in Hong Kong and other developed countries. SmarTone considers that the historical cost standard should be used which will objectively reflect the actual cost incurred by the MNOs.

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