

By Hand / By Email

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<p>RE: Submission for the Licensing Framework for Third Generation Mobile Services Topic: 4.14 Intention to select 3G licensees by evaluation based on merit</p>
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Some industry commentators argue that auction costs are a sunk investment cost for operators, and as such, do not impact the end retail prices charged to consumers, as operators can only charge what the market will bear. I disagree fundamentally with this statement. Whilst auction costs are part of the 'sunk' investment and are fixed, they must either be recouped from somewhere or be written off – banks and shareholders do not provide 'free capital' for auction prices. In this response, I will provide arguments on the advantages of the merit licence award system over auctioning, and why Hong Kong cannot afford to be led down the auction track.

The merit system awards licences based on comparative selection criteria amongst licence applicants, whereas, the auction system awards licences based on the highest bids. Fundamentally, I consider the auction system to be sub-optimal as it emphasises the size of the balance sheet over service quality and innovation. Under a merit system, large and successful companies will naturally command a competitive advantage over new entrants, yet the merit system provides the potential for service innovation by smaller, more vibrant companies. Of course, within the merit system, there has to be safeguards to ensure a minimal balance sheet size, as has always been the case in the Hong Kong merit awards system. Auctions, on the other hand, award licences to companies that can pay the most, but may not necessarily offer the best service or have the highest degree of innovation.

While it is correct to say that an operator can only charge what the market will bear, this holds true only if the market price supports a viable economic return on the total investment cost (fixed and viable) by the operator, otherwise the operator will go bust. This was the case in the US, where operators overbid for their licences and then failed to raise sufficient funding to build out their networks. Whilst irrational auction bidders going bankrupt are a natural part of the free-economy, survival-of-the-fittest process, I consider the industry delay (as the defaulted spectrum is re-auctioned to new entrants) to be a setback that the Hong Kong public cannot afford. To improve our global competitive positioning, we need the best possible cellular infrastructure today, and at the lowest possible price.

Auction costs do not simply go away. Operators must come up with financing for the auctions, and the providers of the capital, regardless of whether it is debt or equity financing, will require an appropriate return. Let us assume that the total addressable 3G cellular market generates 110 units of revenues, and that this remains unchanged, regardless of whether the 3G licences are auctioned or awarded by merit. If capital providers demand an average 10% return, then they will be willing to provide up to a maximum of 100 units of capital. In my view, I would prefer that the 100 units of capital be invested into the 'network' rather than paid out for auction costs.

On face value, the cellular industry does have a high fixed and low variable cost structure – in simplistic terms, once the auction cost is paid and the network built, then the variable operating costs are minimal. However, this is only partly true for the following reasons:

- Network costs increase in step functions, i.e. it may be 'free' to increase subscriber numbers from 50,000 to 99,000, but once the operator reaches network capacity at 100,000 subscribers, it will have to make significant new investments.
- In an intensely competitive environment like Hong Kong, there is constant pressure to improve quality of service (e.g. indoor and in-tunnel coverage) and introduce new value-added services, which results in incremental investments, despite there being sufficient excess voice capacity.
- Due to the dynamic technology changes in the cellular industry, operators need to earn sufficient returns on their total investments in order to generate cash flow to fund investments in new developments such as WAP, GPRS and, eventually, 3G.

On a separate issue, there are concerns about the possible risk of government corruption and favouritism under the merit award system. I believe that this could be resolved easily by making the merit evaluation process more transparent to the public, which in my view, has been lacking in previous licence issuances.

Finally, there are concerns that a merit system gives 'enormous win-fall' profits to the licence winners. This is not the case, as competition will ensure that only efficient and innovative operators survive and prosper. In fact, I believe that an auction system may actually restrict competition, as only the large, national global players will be able to afford the entry price. In the past, Hong Kong operators have enjoyed periods of excessive returns, but this was due to the inherent industry dynamics of demand exceeding supply during the analogue era, rather than the fact that operators had won licences on merit. In 1999, the Hong Kong cellular industry posted billions of dollars of losses collectively, due to the intense competition, despite having won licences on merit.

In conclusion, I argue that the large government revenues generated by 3G auctions are in fact a 'tax' that Hong Kong cannot afford to burden our cellular industry with. With human capital being Hong Kong's most important asset, and cellular infrastructure being a primary input for the development of human capital, an improved and more transparent merit system is the best way to ensure that our global leadership in cellular services remains intact.

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