

Telecommunications in China - More Than Was Bargained For? John Ure¹

The flotation of China Telecom (Hong Kong) shares on the Hong Kong and New York exchanges has been interpreted by many as a sign of breakthrough in the Ministry of Posts & Telecommunications (MPT) opposition to foreign direct investment in China's telecoms sector. It isn't, and in fact it strengthens the MPT's hand within China to resist major changes in policy to FDI.

This is yet another example of the basic and common misconceptions surrounding China's policy-making process which continue to trip up international telecommunications companies hoping to make an entry into China's markets. Wishful thinking, a lack of detailed analysis and a misreading of the facts combine to perpetuate the myth that China is moving towards opening its telecommunications markets to foreign direct investment as a means to fund much needed network expansion. The fact is that the MPT remains adamantly opposed to concessions on FDI in networks or network services.

I argue not as a securities analyst but as an economist with a special interest in telecom policy issues, that the China Telecom deals heralds no such opening, but rather illustrates very nicely that China's State Council and the MPT in particular have considerably eased the pressure to open up the telecoms markets by taking shrewd advantage of Hong Kong as one of the world's leading financial centers. Red chip stocks are riding high on China business sentiments with premiums of 30 per cent or more over fully discounted earnings valuations. In fact, China telecoms interests have been moving into Hong Kong discretely but determinedly for some time. The following table illustrates some of the China plays.

Table 1
China's holdings in Hong Kong's telecoms

China Telecom (Hong Kong) has acquired 5.5 per cent shares of Hongkong Telecom (Cable & Wireless subsidiary) with an option for 29 per cent.
Everbright (China) buys 7.7 per cent of Hongkong Telecom shares from CITIC (China) and becomes an institutional investor in China Telecom (Hong Kong).
China Telecom (Hong Kong) share flotation in Hong Kong and New York; institutional investors include Hutchison, New World and Wharf Holdings, the companies behind Hong Kong's three new wireline telecoms companies.
China Strategic Holdings (China) acquires Star International Telecom (Hong

¹ Dr John Ure is associate professor at the School of Business and director of the Telecommunications Research Project, University of Hong Kong.

Kong)

MPT's Town Khan becomes shareholder in Smartone, a Hong Kong GSM mobile cellular operator.

China Resources Ltd is a shareholder in People's Telephone Company, a Hong Kong PCS operator.

China Travel Services Ltd is a shareholder in Mandarin Communications Ltd, a Hong Kong PCS operator.

Tesonic (Ministry of Electronic Industries) and Golden Tripod (Xinhua investment company) set up Hong Kong joint venture with CCT Telecom

Casil Telecom (China Aerospace) listed in Hong Kong

MPT's subsidiaries in Hong Kong: Telpo (procurement), Putai (posts), Tianbo Jiyou Gongsi and Jianya Gongso (trading)

The first error that analysts frequently make is that China's network growth, from 20 million to 85 million exchange lines 1990-1995 and to 170 million by 2000, simply cannot be financed without resorting to FDI. This needs to be put into perspective to make the point clearly. China, with less than 5 fixed wireline telephones per 100 population, is to leapfrog in five years the largest telecommunications network in the world, the USA which in 1995 had 164 million exchange lines built out over many decades, and 63 phones per 100 population. On the cellular front, China has around 7 million users and MPT's forecasts for 2000 have risen from 18 million to 25 million and now to 30 million. Some analysts believe the real figure will be closer to 45 million.

Figures on this scale indicate that China is rapidly moving away from a supply-push to a demand-pull economy, but that has an important financial implication. It means that resources become revenue-based rather than having to be allocated to the provincial Posts and Telecoms Administrations (PTAs) - see Table 2 for revenue growth. And as the revenue base grows on both the wireline and wireless networks, so the ability of the PTAs to raise finance from domestic sources, through arrangements such as leaseback, and from foreign sources, especially from equipment suppliers offering attractive financial packages, but also from offshore and overseas China investment funds, also grows. In fact, around 80 per cent of China telecoms investments come directly from revenue sources (about 35 per cent from installation or connection charges, and 40 per cent from usage charges) and other domestic sources, and no more than 20 per cent from foreign sources, although this has grown from around 15 per cent in the early 1990s and is likely to grow a few percentage points to 2000.

Table 2
MPT Revenues

Year	Telecom Turnover
2000	\$34 billion (e)

1997	\$19 billion (e)
1996	\$15 billion
1995	\$11 billion
1994	\$7 billion
1993	\$4.3 billion
1992	\$2.6 billion

These figures indicate a strong revenue base. Tariff rebalancing could boost them further. The MPT has begun to edge up local call charges from a very low base, while reducing long-distance tariffs to stimulate usage, and in 1977 dropped IDD charges by a cumulative 51 per cent. Since net international revenues in 1996 were only 16 billion yuan, under 15 per cent of total revenue, the risk of major revenue loss (assuming short-run demand is price inelastic) is slight, while the longer-term prospects for growth are good. Moreover, by cutting international tariffs now, the MPT is also undermining one of the potential sources of revenues for its rival Unicom and thereby one of the bargaining opportunities for foreign companies intent upon breaking into the China market.

The Bargaining Model

This point brings us to the crux of the matter. Policy-making in China is a complex affair involving the inter-play of many different interests subsumed under the national priorities as determined by the Party leadership, and as reflected through the State Council and other organs of government. For policy decisions to be taken a lengthy process of bargaining is involved, but the key question is how to get the issue to the top of the State Council agenda. Telecommunications has fleetingly reached the top of the agenda several times because it is recognised as a strategic sector, not just for security reasons but because the efficient and effective flow of information is vital for the Party and the government to manage the rapid diffusion of China's economy and the government's economic reforms. Telecommunications is important for another reason. It is highly profitable and provides the State with one of its major sources of revenue. For that reason many other ministries want to get into the market themselves. Led by the Ministry of Electronic Industries (MEI) the ministries of Railways and Energy lobbied to launch China's second carrier, LiangTong (Unicom). The People's Liberation Army (PLA) is another important player. Partly to divert the threat of competition, the MPT has entered a joint venture with the PLA to build and operate CDMA cellular networks in competition with the MPT/PTA's GSM digital networks. This alliance effectively blocks a PLA-Unicom alliance.

The *domestic* bargaining model implied by these developments works at both horizontal and vertical levels. Ministries and State Commissions vie with each other to gain entry or influence over different aspects of the national information infrastructure. The Ministry of Film, Radio and Television, for example, is looking to use cable TV as a vehicle into

telecommunications, internet services and inter-active commercial services and appears to be resisting MPT efforts to build jointly. Yet at some provincial levels, for example in Shanghai, the two have been instructed to co-operate. At provincial level, there is often rivalry between the fiat of the ministry in Beijing and the municipal government. Again, taking cable TV as an example, while the Ministry would like to see a single network under its supervision, in many provincial capitals there are two networks, one run by the provincial government. In every area of information network services in China there are players positioning themselves. Internet services are another example, where turf battles rage over where ownership and control lies, between network builders, usually ministries; systems integrators, the most prominent is the MEI-backed JiTong Corporation; suppliers of the databases, such as the State Information Centre; and service suppliers - for example, there are currently over one hundred internet service providers in mainland China. Developments are being driven by trial and error, and trial of strength, which, unlike in the West, rarely involve zero-sum games but more usually involve bargained outcomes.

There is a second *international* bargaining level. This works all the way down from pressures from US and other trade negotiators, and the bargaining that takes place with multilateral organizations such as the WTO, the World Bank and the IMF, to the negotiations with overseas equipment suppliers over foreign state-backed soft loans, vendor credits, technology transfer issues, joint-venture and management issues, to the entry strategies of overseas corporations wanting to gain access to China's growing services markets. The range and scope of bargaining has widened with the devolvement of financial responsibilities and purchasing decisions to the PTAs since the early 1990s. But this has not simplified the entry process. On the contrary it now requires overseas entrants to China's telecommunications markets to maintain head-offices in Beijing, representative offices in one or more provincial capitals, and to deal with numerous vertical layers of central and local state bureaucracy and enterprise, and a broad horizontal range of ministries, commissions and other interested parties. On the one hand, this allows for widening business opportunities, on the other it involves more time for negotiation and due diligence.

Managed Competition

Negotiation in China is essentially an endless process. Unlike the West, where negotiations can be confrontational but decisive, concluding in a commercial contract which has been put through the shredder of corporate lawyers, in China negotiations can be ritualized and frequently conclude with an agreement, at least so far as the Chinese side are concerned, to work together, which means to thrash out problems and difficulties as they arise in accordance with ill-specified criteria. This is not perversity on the Chinese side, although the Chinese have learnt very well how to keep the pot from ever boiling over. It is a genuine reflection of how the bargaining process works within China, and it is a guaranteed method of keeping the options open with foreigners in areas where uncertainty prevails. And in China's telecommunications sector there are

many uncertainties ranging from policy-making to the choice of technologies, from business plans (where's the revenue coming from?) to commercial and contract law.

But over and above these endemic problems for foreign companies trying to do business in China is a bargaining-policy positioning by the State Council and the MPT in particular. It can be called 'managed competition': in short, China manages the market and foreign companies compete to get into it. This explains why so many foreign companies complain in bewilderment that China is such a large market, yet they can't make money from it! For example, on 8 November 1996 the Hong Kong Standard was quoting an assistant to the vice-president of Shanghai Bell as saying 'The competition is much more severe than in other countries. Some of our prices are now only a third of what you see in other countries.' This is telling. Switches now cost less than US\$60 a circuit in China, and that implies that even if only 50 per cent of switching capacity is connected to subscribers premises, total line costs are less than US\$800, and that allocates all overheads to line costs.

We began by suggesting the view that China could not hope to achieve its build-out plans without resorting to FDI was wishful thinking, based upon a lack of detailed analysis and a misreading of the facts. Often the rule-of-thumb cost for a connected local exchange line is between US\$1200-1500, but this ignores the fact that, starting from such a low base, China can use the most cost-effective technologies. An estimate made in 1992 by David P.Reed (*Residential Fiber Optical Networks: An Engineering and Economic Analysis*, Artech House) suggested a modern electronic digitally switched and transmitted network need only cost US\$690 per local loop line, and China is right in line with this estimate. (When rural penetration rates surge the overall average network costs will change, but it probably makes better sense to view and cost each provincial network separately. From an investment point of view this is certainly true. The targets for the year 2000 are penetration rates of 30-40 phones per 100 population in the major urban centers and an average 10 phones per 100 population across the whole of China.)

The Future of the Bargaining Model

As China steps into the information age, high on the list of priorities are information systems which provide Party and government, state enterprise and banks, farmers and China's rising middle-classes, with economic intelligence, trade and industry data and market signals. The opportunities for telecommunications, computer and information technology firms to provide equipment and components, build networks and integrate systems, design data bases and search engines, offer services and access to services, and provide finance, management and consultancy will be enormous.

Whatever disappointments have dampened the spirits of overseas companies to date, these opportunities will bring them flocking to the bargaining table, seeking domestic partners with local influence to further open the doors. Never mind that for those strictly

adhering to the thought of Deng Xiaoping information will be the very last frontier to have the doors flung open, the competition will be as fast and furious as always. China will do very well out of it, especially if China manages to ride the learning curve through the transfer of technology and management skills. Without that, China simply cannot afford to open its doors as the WTO and US Trade Department officials would like. That is the end-game for China, that is what the highest level of bargaining is about.

To supervise the bargaining game, at both the domestic and international level, in 1996 the State Council upgraded to status the National Committee for the Informatization of the Economy to a Leading Group. There has been discussion of it being upgraded further to a State Commission that would become the overall policy-maker for telecommunications and IT, but outside observers always compress the timescale on which China's bureaucracy works. It is, after all, a *bargaining* process and not simply a decision-making process. The Leading Group has some twenty members, chaired by a vice-premier, with representatives of all the primary interest groups from state commissions and ministries. So far it has determined, in documents not yet made public, that the NII shall be as protected as telecommunications from foreign influence or control.

This does, however, leave open the question of what China will *give* in the bargaining game. To date it has not been required to give much at all, just a window of opportunity to foreign equipment suppliers and carriers wide enough to catch them elbowing past each other to get to the negotiating table. At the APEC Ministers meeting in Manila in 1996 China gave hints that it was considering opening its value-added services (VAS) markets to foreign participation, without committing to equity investment. It made no mention of value-added *network* services (VANS) and the presumption must remain that network management will remain off bounds. In 1993, State Council Document 55 established 'provisional' measures for the liberalization of VAS such as EDI, e-mail, audiotext, videotex and other information services. Radio mobile communications were separately listed as requiring a license from the MPT, but would logically be deemed VANS rather than VAS unless resale services are envisaged. The trial use of foreign investment in joint ventures was decreed by the MPT in 1994 where by foreign investors would participate in operating profits according to their proportion of investment, but here the valuations placed upon assets would be a problem. In 1995 the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) classified foreign investment in telecommunications 'operation and management' as prohibited, but some observers saw this as leaving open non-equity options.

The Final Step?

Will China take the final step towards FDI in the telecommunications sector? There are certainly pressures in that direction. Around the domestic bargaining table there are players who would welcome FDI for the finance, for the technology and for the management expertise it brings. Unicom is one obvious candidate. Some of the PTAs

are potentially also interested. Many China enterprises are certainly interested, and maybe even some work units within the PLA. The international bargaining table is full of such pressures. But for as long as China can rely upon alternative modes of raising the capital and gaining access to technology and know-how these pressures are largely resistible, not least because there are plenty of carrots that China can dangle before foreign noses.

The more realistic question is how will China experiment with different forms of foreign participation, which will ultimately lead to FDI? Many observers are putting their faith, wrongly, in the drawing up of a Telecommunications Law. The MPT has been under pressure from its domestic competition to separate its roles of policy-maker, regulator and operator, and in doing so the MPT will be forced into a more codified position on what foreigners can and cannot do. But the MPT has been most successful in forestalling any such law, and it is most unlikely to see the light of day before 1999. In the meantime the MPT has room to maneuver, to allow semi-official concessions to overseas companies to enter gray areas between loan finance, equipment supply, management consultancy and arms-length joint venture participation in the operating revenues. The areas opened in these gray-areas have mostly involved paging and trunk radio and some cellular mobile operations. At least high-technology broadband network for video-conferencing in Guangzhou was permitted, but once the technology transfer had taken place the operation seems to have stalled.

At the turn of August and September 1997 China cutover its 100 millionth telephone exchange line, well on its way to its 2000 target of 170 million. In the provision of basic services China has little difficulties, except for increasing the successful call rate and boosting revenue-generation through greater usage. In mobile communications China has a rising star and cash-cow rolled into one. Where China is weakest is in developing high-technology applications, especially in high-speed data processing and networking, and multi-media. Directly or indirectly China needs to finance development in that area, so the pressure to experiment is a given. We should therefore watch for the experiments, not for the big breakthroughs, and anticipate more of the managed competition model that has worked so successfully for China, rather than major concessions to individual companies. In short, foreign companies need to push aside wishful thinking, rely more upon their own good homework, and to face the facts: China's bargaining model is telecommunications with Chinese characteristics.