

Resale of Mobile Communications Services Back on the Menu in China: But Only a Few Seats at the Table

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Resale of Mobile Communications Services Back on the Menu in China: But Only a Few Seats at the Table

Notwithstanding the high hopes surrounding China's entry into the World Trade Organization ("**WTO**") over 10 years ago in 2001 with the commitment from China to open up both basic telecommunication services ("**BTS**") and value added telecommunication services ("**VATS**")¹, the actual opening up of China's telecommunications industry has failed to match the expectations of foreign investors going into WTO. The primary government authority regulating the telecommunications and Internet industries in the People's Republic of China ("**PRC**" or "**China**") is the Ministry of Industry and Information Technology ("**MIIT**"), which so far has adopted a quite protectionist stance in opening up China's telecommunications and Internet markets to overseas operators. Over ten years on since WTO, whether you look at BTS (such as fixed line and mobile network communication services) or VATS (like broadband access services) they are still, across the board, almost exclusively provided by one or more of the three main telecommunications carriers in China, namely, China Telecom, China Mobile and China Unicom (collectively, the "**Chinese Telecommunications Carriers**") often under services marketed under sub-brands that obscure the link to the parent. Although each one has a listed arm on both the Hong Kong Stock Exchange and the New York Stock Exchange, they are still ultimately controlled by the Chinese state and operated for the most part as state-owned enterprises.

Each has enjoyed phenomenal growth which has propelled them into a select group of the world's largest telecommunications carriers. China Mobile for example, is the world's largest mobile phone operator based on the number of subscribers. Driven by China's economic growth, this comes as no surprise given the exponential growth in mobile and Internet users over the past decade. The picture that emerges from this is that MIIT wants the Chinese Telecommunications Carriers to reap the benefits of China's growth. However, our experience suggests that protectionism breeds complacency and curtails innovation at the expense of the end consumer, who ends up burdened with high subscriber fees and sub-optimal choice. Given the virtually unassailable position now held by the Chinese Telecommunications Carriers, and with an eye to the future development of the telecommunications industry, MIIT has recently shown signs of gradually loosening its grip on BTS, although not where foreign investment is concerned. In this note, we examine the changes to the regulatory environment in the mobile communications resale services sector which reflect this approach. Before going into the analysis, it is important to understand the background to the regulatory environment in China's telecommunications industry.

1. Regulatory Background

In China, telecommunication services are divided for regulatory purposes into two main categories, namely BTS and VATS. The provision of either BTS or VATS in China requires the service provider to obtain a BTS operating permit ("**BTS Permit**") or a VATS operating permit ("**VATS Permit**") respectively, each of which is issued by MIIT at the central level or through its local branches. The types of telecommunication services falling under BTS and VATS are listed in the *Circular of the Ministry of Information Industry on the Readjustment of the Classification Catalogue of Telecommunication Services* (the "**Telecommunications Catalogue**") issued by the predecessor of the MIIT, the most recent version of which came into force on 1 April 2003 ("**2003 Telecommunications Catalogue**"). In line with China's WTO commitment, foreign investors are only permitted to apply for a BTS Permit or VATS Permit via establishing a joint venture foreign invested telecommunications enterprise ("**FITE**") with a Chinese partner. In terms of shareholdings in the

¹ The People's Republic of China Regulations on Telecommunications promulgated by the State Council, effective 25 September 2000 ("**Telecommunications Regulations**"), Art. 8

FITE, in line with China's WTO commitments, foreign investors can only own up to fifty percent (50%) of a VATS provider and up to forty-nine percent (49%) of a BTS provider.

Notwithstanding the letter of the law, as mentioned above, MIIT has adopted a protectionist stance and has used its discretionary interpretational authority to limit the number of FITEs established to only 20 or 30 FITEs since China's WTO accession, all in the VATS area. The requirements and process for establishing a FITE are extremely complex and time-consuming. On the other hand, it is relatively simple for a domestic capital entity in China (i.e. an entity whose shareholders are all PRC nationals or PRC incorporated entities) ("**Domestic Company**") to obtain VATS Permits for many services in the 2003 Telecommunications Catalogue. MIIT has also consistently interpreted China's WTO commitments in the most restrictive manner possible, thereby limiting the services which it considers as being open to foreign investment. This, combined with the cash-rich positions of the Chinese Telecommunication Carriers, who feel able to buy in any new technologies they need and are not motivated to do any form of joint venture with a foreign operator that might cannibalise their booming domestic revenues add up to a difficult environment for foreign investors seeking opportunities in China's huge market. It explains why many have resorted to legally more questionable work-arounds such as the Variable Interest Entity ("**VIE**") structure or a variant.

2. Classification of the Resale of BTS under the Telecommunications Catalogue

The resale of BTS was previously classified as a form of hybrid service in the prior version of the Telecommunications Catalogue issued by MIIT in 2001 ("**2001 Telecommunications Catalogue**"): it was classified as BTS, but administered by reference to VATS:

"Resale of basic telecommunication services

Wide area radio mobile telecommunication and analogue trunked telecommunication services under item (II), very small aperture terminal (VSAT) telecommunication services under item (III), wireless paging service under item (VIII) and resale of basic telecommunication services under item (IX) shall be administered by reference to value-added telecommunication service business."

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第(二)项业务中的大区制无线电移动通信和模拟集群通信业务,第(三)项业务中的甚小地球站(VSAT)通信业务,以及第(八)项无线寻呼业务和第(九)项转售的基础电信业务比照增值电信业务管理。

Under the 2001 Telecommunications Catalogue, examples of BTS services include fixed network domestic direct dialling and local services, mobile telecommunication services and internet and other data transmission services which are the basic types of voice and data telecommunications services. Therefore resale of BTS includes the resale of mobile communications.

There was a flurry of interest from foreign investors at the time the 2001 Telecommunications Catalogue was issued, scenting an opportunity. The reference to 'administered by reference to VATS' was interpreted by some as meaning you could do simple resale with a VATS Permit: The reaction of MII, the predecessor to MIIT at the time was one of exasperation with being bombarded with so many calls from foreign investors. Given that China had made no specific WTO commitment to open up resale, MII's position at the time was that it was not open to foreign investment. The 2001 Telecommunications Catalogue, as with all of its

successors, needs to be read not as a list of what is open to foreign investment, but as more of a list of services that China recognises as being subject to permitting requirements for domestic participants: what is open to foreign investment comes down to MIIT's interpretation of China's WTO commitments. It does not follow that all the services set out in any telecommunications catalogue are automatically open to foreign investment.

Then in 2003, MIIT issued the 2003 Telecommunications Catalogue which removed resale of BTS from the Telecommunications Catalogue altogether. This appears to have been a calculated move by MIIT to protect the Chinese Telecommunications Carriers from both domestic and foreign competition. Considering that the China Telecommunications Carriers were looking to expand and list overseas, it was perhaps justified by the desire to maximise the value of the State's holdings on listing overseas, and hence it was not the right time to allow other service providers (domestic or otherwise) to enter the market and reduce their market shares. After its disappearance from the 2003 Telecommunications Catalogue, it was unclear if the resale of BTS and mobile communications were permitted under PRC law.

After ten years of silence on the point, new rules issued by MIIT in quick succession within the space of five months point to a limited liberalisation and have reinvigorated interest in resale. We discuss these in turn below.

3. Resale Services Notice

The first critical development was the issue of the *MIIT Circular on Soliciting Public Opinions on the Pilot Program for Mobile Communications Resale Services (Draft for Soliciting Comments)* on 8 January 2013 by MIIT ("**Draft Resale Services Circular**"). After slightly more than four months of internal reviews and consideration, the Draft Resale Services Circular was finalised and MIIT issued the *Pilot Program for Mobile Communications Resale Services* effective 17 May 2013 ("**Resale Services Circular**").

It is important to note at the outset that the Resale Services Circular refers only to the resale of *mobile communications services* as opposed to (the much broader) BTS. Article 2 of the Resale Services Circular defines resale of mobile communications services as the purchase of mobile communications services by a reseller from a BTS provider who owns a mobile network whereby the reseller repackages the services under its own brand and sells the services to the end users (commonly known as a Mobile Virtual Network Operator or "**MVNO**" arrangement). As a reseller, it does not need to own the network on which the mobile communications services are provided (the cost of building such a network in China nowadays would likely be prohibitive), but is required to set up its customer service system and other support systems (billing and so forth) as needed. This requirement comes as no surprise, as the value-add from a reseller is essentially derived from better 'soft skills' as compared to an incumbent such as customer service, responsiveness to customer complaints and so forth.

A key distinction between the Draft Resale Services Circular and Resale Services Circular are the provisions on the capital structure of the service provider. Under the Draft Resale Services Circular, the service provider had to be a Chinese capital privately-owned company (中资民营企业). It was unclear in the Draft Resale Services Circular whether it meant that the company must be wholly owned by PRC shareholders (i.e. a Domestic Company) or if the PRC shareholders must hold a majority interest. The wording in the Resale Services Circular clarifies this point. Under the Resale Services Circular, instead of a Chinese capital private

company, the wording now refers to a privately-owned company (民营企业). The Resale Services Circular further specifies that the private capital company needs to be a company established in accordance with relevant Chinese laws and which has private investors holding fifty percent (50%) or more of its capital, with the largest single investor being a private investor. This clearly does not preclude a tie-up with an incumbent. It precludes Hong Kong, Taiwan, Macao and other foreign investors from investing in the private capital company, but there is a carve out for private capital companies which are listed abroad. In this case, foreign capital cannot exceed ten percent (10%) or more of the shareholding capital and the largest shareholder must be a Chinese shareholder. This very narrow exception means that foreign investors are essentially excluded from the market. This is, of course, disappointing and not to the benefit of Chinese consumers, as by definition no privately-owned company in China will have experience of operating this kind of business, but somewhat predictable given the history of foreign participation in the industry. Query whether this will lead to a swathe of VIEs in relation to the companies allowed to participate in the MVNO trial (which is discussed further below).

Both the Draft Resale Services Circular and Resale Services Circular state that the mobile communications resale business is classified as a Class II BTS, but shall be administered by reference to the provisions on VATS (similar language as in the 2001 Telecommunications Catalogue). Importantly, they clarify that the reference to VATS means that the service provider will need to submit the application materials and fulfil the conditions applicable to an applicant for VATS under the *Measures for the Administration of Telecommunication Services* issued by MIIT effective 10 April 2009 and the Telecommunications Regulations. This is helpful as neither the 2001 Telecommunications Catalogue nor the Draft 2013 Telecommunications Catalogue (defined below) expand on or explain the meaning of 'administered by reference to VATS'.

Apart from the shareholding requirements, the Draft Resale Services Circular and Resale Services Circular also list a number of requirements which include the:

- (a) personnel of the service provider: for example, for service providers operating within a single province or municipality under direct central government administration, at least 30 employees and managers with information technology and management backgrounds from the junior to higher level positions are required and for service providers operating nationwide or on cross-provincial/municipality under direct central government administration, basis at least 50 employees will be required; and
- (b) establishment of a specialized customer service department, security management department and service quality management system.

Paragraph (a) above imposes a significant level of fixed overhead on potential MVNOs. The Resale Services Circular includes an appendix which discusses in more detail the requirements on the educational backgrounds and specialisations of employees, premises and equipment, network and security facilities. We have set these out in Appendix 1 to this note. The agreement between the reseller and the BTS service provider (i.e. one of the Chinese Telecommunications Carriers) cannot contain any exclusivity clauses (i.e. you cannot prevent others from tying up with one of three incumbents by entering into an exclusive arrangement) as this would essentially close the resale market to competition and shut out participants. There is also the requirement for disputes to be mediated by the competent telecommunications authority, which is basically the local MIIT. This makes it difficult for privately-owned MVNOs given the historic ties between MIIT and the Chinese Telecommunications Carriers.

4. Telecommunications Catalogue 2013

The second critical development was the issue of a draft of the revised *Telecommunications Services Classification Catalogue* by MIIT on 24 May 2013 ("**Draft 2013 Telecommunications Catalogue**"). MIIT is, as of the date of writing, soliciting public comments on the draft. The Draft 2013 Telecommunications Catalogue represents a wholesale updating of the 2003 Telecommunications Catalogue which was widely seen as hopelessly out-of-date and as failing to capture many of the key emerging services; even some of the descriptions of the pre-existing services seem dated as the technology or the way it is used has moved on (e.g. Cloud services, social media and so forth.). Ten years is a long time in technology terms and the changes in the Chinese market over the last ten years have outpaced those in most other jurisdictions, thereby creating an even bigger gap between 2003 and now.

The Draft 2013 Telecommunications Catalogue has reinserted the resale of BTS as a Category II-type BTS and also included, as a sub-category, the resale of mobile communications as follows:

"Resale of basic telecommunication services

Resale of basic telecommunication services refers to the purchase of telecommunications services or lease of network facilities by the commercial service provider from other operators who have the right to operate basic network infrastructure facilities, whereby the telecommunications services are repackaged under the commercial service provider's own brand and sold to the customers.

Resale of mobile communications services

Resale of mobile communications services refers to the purchase of mobile communications services by the commercial service provider from operators who have the right to operate mobile network basic infrastructure facilities on a wholesale pricing basis, whereby the telecommunications services are repackaged under the commercial service provider's own brand and sold to the end customers.

The mobile communications resale services operator does not set up its core network and service nodes but can set up its billing and service management platforms. The service is provided through the network of an operator which has the right to operate mobile network basic infrastructure facilities."

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Interestingly, the Draft 2013 Telecommunications Catalogue has listed the resale of mobile communications as a stand-alone category. Under the 2001 Telecommunications Catalogue, resale of BTS appeared to be broader in scope, but in effect already encompassed the resale of mobile communications.

Nonetheless, the express inclusion of the resale of mobile communications services in the Draft 2013 Telecommunications Catalogue is consistent with the issue of the Resale Services Circular.

Curiously, there is no reference in the language above to resale being administered by reference to the VATS requirements in the Draft 2013 Telecommunications Catalogue, but at the very least, the requirements which apply for VATS will apply to the resale of mobile communications services by virtue of the Resale Services Circular. It may be that the reference to VATS will be included in the final version of the Draft 2013 Telecommunications Catalogue.

5. One Step at a Time

The inclusion of the resale of BTS and resale of mobile communications services in the Draft 2013 Telecommunications Catalogue, as well as the issue of the Resale Services Circular within a span of one month should be seen as overall positives for the market, although it remains to be seen how enthusiastically (or otherwise) the incumbents embrace this development, which could reduce their own market shares (although they will be getting network usage fees from the MVNOs). Experiences in other markets suggest that the negotiations with the incumbents will not be easy. Consumers will benefit from some limited competition amongst service providers which will hopefully create downward pressure on prices. Nonetheless, there is little in this for foreign investors: experience tells us that MIIT will only open the doors in this regard when it feels the time is right, with the vested interests of the Chinese Telecommunications Carriers and other domestic participants being its first priority rather than those of foreign investors or the Chinese consumer.

Furthermore, neither the resale of BTS nor mobile communications appear anywhere in China's WTO accession documents, and, as noted above, the rule of thumb has been that unless MIIT decides otherwise, MIIT's reading is services not expressly included in China's WTO commitments are not open to foreign investment.

The recent moves by MIIT coincide with the central government's push for more private businesses and market forces to play a larger role in China's economy. Since assuming office in March 2013, the new leadership led by the Chinese President, Xi Jinping, and Prime Minister, Li Keqiang, have taken an aggressive approach in introducing policies to promote private investment in the country's economy and reducing the state's role. This is essentially a revamp of the country's growth model which has hitherto relied on government intervention and funding to fuel its economic growth. The consensus is clearly that continued government spending and investment is not sustainable given the global economic conditions and China's need to transform itself into a more services-oriented economy as manufacturing shifts to cheaper centres, so the authorities must now promote private investment and competition into the markets. The telecommunications industry is not immune to these changes, but as a highly sensitive and strategic industry, as with the banking and energy industries, changes will only occur gradually.

To date, rumour has it that MIIT will approve at least six domestic privately-owned service providers to participate in the pilot program between June and October this year. It will be interesting to see which home-

grown private entities will be approved by MIIT to compete with the Chinese Telecommunications Carriers and whether these will be true arm's length competitors or entities with strong connections to the incumbents (and possibly even joint ventures with the incumbents). Rarely have we seen such a business opportunity of this magnitude open up overnight in China telecoms, and hence we imagine that competition for places on the trial will be fierce. Presumably none of the six will have experience of operating this type of business given that it has only just opened up; the Chinese consumer might ultimately have been better served by allowing joint venture FITEs to participate in the trial although realistically it would have taken too long to put a FITE together given the long and complex approval process and the fact that the trial starts this month. However foreign investors can take some comfort from the fact that even this small step forward is probably a necessary intermediate step before MIIT will feel comfortable with a wider opening up of the market.

Appendix 1

Main Requirements of Service Providers under the Resale Services Circular

1. Geographical Scope

The geographical scope for the provision of the services will be in accordance with the scope as prescribed in the business contract with the basic telecommunications operator.

2. Personnel Educational Background

- Junior level: graduates of technical/vocational school (minimum 7 years after graduation), associate degree (a degree awarded by junior colleges) holders (minimum 3 years after graduation), bachelor's degree holders (minimum 1 year after graduation) and master's (or above) degree holders.
- Mid-level: associate degree (a degree awarded by junior colleges) holders (minimum 7 years after graduation), bachelor's degree holders (minimum 5 years after graduation), master's degree holders or double bachelor's degree holders (minimum 3 years after graduation) and doctoral degree holders.
- Senior level: bachelor's degree holders (minimum 12 years after graduation), master's degree holders or double bachelor's degree holders (minimum 6 years after graduation) and doctoral degree holders (minimum 3 years after graduation).
- Technicians shall be assessed according to the junior level requirements and skilled technicians and above shall be assessed according to the mid-level requirements.

Personnel Specialisation Background

- Information technology and telecommunications personnel: Electronic Information and Computer specialisation under the "Professional Directory of Undergraduate Course General Institutes of Higher Education (2012)".
- Management personnel: Economics, Fiscal Science, Finance, Economics and Trade, Management Science and Engineering, Industry and Business Administration, Public Administration, E-commerce specialisation under the "Professional Directory of Undergraduate Course General Institutes of Higher Education (2012)".

3. Premises and Equipment

- **Premises:** Establish at least one office within the province (municipality, district) where the pilot program has been approved with proper staffing.
- **Customer services system:** Setup a customer services call centre, providing 24 hours seven days a week service which is adequately staffed based on the scale of the operations.

4. Network and Information Security Safeguard Measures

Organization and system safeguard requirements

- Establish a specialized department and personnel to ensure network and information security and the coordination of security supervision.
- Provide implementing measures for customer identification information management.
- Set up customer information protection system.

Network and information security technical supporting capacity requirements

- Establish the necessary network safety protection technical measures in accordance with the relevant laws and regulations (including the Telecommunications Regulations, the *Administrative Measures for the Security Protection of Communication Networks*).
- Establish the necessary information safety technical measures to satisfy and protect the user information stored.
- Possess the necessary emergency response safeguard mechanism.

5. Application Materials

- Application materials include (standard forms below are appended to the Resale Services Circular):
 - (i) Application form;
 - (ii) General information regarding the applicant;
 - (iii) Service development and implementation plan form;
 - (iv) Set up of business locations for mobile communications resale services;
 - (v) Network and technology plan form;
 - (vi) Network and information security safeguarding measures form.
- Letter of undertaking (a template is appended to the Resale Services Circular)
- Other required application materials and information including:
 - (i) business license, articles of association, detailed equity structure, identity of shareholders, business license of branches (if any);
 - (ii) capital verification report or audit report;
 - (iii) the identification, resume, professional title certificate, evidence of telecommunications industry work experience of each of the legal representative, chief technical personnel, chief financial officer, senior management personnel and other key employees;
 - (iv) the mobile communication resale services business contract entered into with the basic telecommunications operator;
 - (v) company website domain name and trademark certificate (if any); and
 - (vi) other materials required by the telecommunications administrative authorities.

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