



ENTER THE DRAGON

NETWORK PROVIDERS HAVE EVERY REASON TO BE EXCITED BY THE UNTAPPED POTENTIAL OF THE CHINESE TELECOMS MARKET, FINDS GUY MATTHEWS.

> **There is** no telecoms market on earth that comes close to China for raw commercial potential.

In fact with its vast population, until recently starved of the most mundane of commodities, China is the world's biggest and fastest-growing marketplace for pretty much anything you can think of.

The speed with which China is hungrily catching up with the developed world is epitomised best by telecoms.

We're talking about a country which had, according to the ITU, only 2.8 million fixed-line telephone lines in 1984. By 1994 this figure had risen to 27 million. By July 2000, there were 125 million lines, and today this figure is not far shy of 200 million.

China in fact lags behind only the United States in fixed-line subscriber numbers. And at a current rate of roughly two million new lines per month is expected to overtake the US before 2005.

Mobile growth is yet more spectacular.

China is typical among developing markets in that mobile subscriber numbers are in excess of those for fixed lines. According to technology research company Gartner, 17.5% of Chinese people now own a mobile phone, having only recently overtaken fixed-line penetration of 17%.

With its 200 million plus subscribers, China is already the world's largest market for mobile telephony. Analysts at Merrill Lynch expect this figure to grow to about 350 million over the next five years if mobile connections continue to grow by four million or more a month. And all this in a country where large swathes of the population still lack the wherewithal to buy a can of Coke.

The size of the existing market, the scope for its potential expansion and the speed at which it is current expanding combine to explain why China is a market that a lot of people, both outside and inside China, want a piece of.

As Bill Holt, director of sales and

customer service with Hong Kong-based Reach Global Services puts it: "If there's one still largely untapped world market for telecoms that everyone ought to be focusing on, it's China. It's got 1.3 billion people, and it's the world's fastest growing economy. What more do you need to know?"

But for outsiders looking in, there are problems.

Says Holt: "It's not a liberal market yet. It's managed and controlled by a number of government-controlled carriers. Outsiders, like us, are pretty much restricted to bringing traffic into China from the outside, not in and around from the inside. It's vital to distinguish 'into' and 'in' when talking about Chinese telecoms."

China has a long tradition of wariness of outside commercial interests, and has legislated to protect its indigenous telecoms industry from potential usurpers.

All direct foreign investment in China's

telecoms was banned until 2001. Even now, it won't be until the end of 2004 that any outside company can own as much as 49% of a Chinese telecoms company, in other words have a non-controlling interest (see box for details of current rules governing foreign ownership).

The most effective form of entry for outsiders at present is via a joint venture, and there are plenty of examples of these by US and European companies keen to get into the market on any terms (see box on foreign investment in China p28).

Something of a deluge can be expected when key regulatory milestones are reached. "When the end of 2004 comes around, all sorts of telecoms companies are going to rush in to take advantage of the markets high-margins and stable pricing," predicts Holt. "They will need a Chinese partner with a controlling interest, but many will gladly settle for that."

The stability of pricing in China owes everything to a lack of competition, so the high-margin window is likely to be small once the market opens more fully.

That the market has been and continues to be so heavily state-controlled is a source of much frustration for outsiders, and rather defies what everybody thought China had promised some time ago. But the fact is that while China talks about "liberalised access", it continues to interpret the concept on its own terms.

Even internally, the market is only just beginning to open up, but again, it's a form of openness that seems pretty closed to anyone accustomed to true competition.

Agatha Poon, senior analyst with the Yankee Group, and based in Tokyo, has kept a close eye on the way in which China has managed its own telecoms interests. "It's been a pretty closed market in the past, with [state incumbent] China Telecom enjoying a virtual monopoly. If you want last-mile connectivity, you still have to go through China Telecom."

She says the market was restructured in mid 2002, allowing the emergence of a rival to China Telecom in the form of China Netcom. But she warns: "It's still not a level playing field, with China Telecom controlling 70% of the country's network resources."

The Chinese government's stance on regulatory matters is not merely restrictive, but also frequently confusing and annoying for outsiders.

Interested outside parties have been puzzled by the government's uncertainty and indecision over the adoption of 3G mobile services, perplexed by its patchy and



inconsistent enforcement of rules governing mobile and fixed line operators, and wrong-footed by surprise decisions on matters such as foreign investment in Chinese telecoms companies.

No wonder when the watchdog employed to look out for irregularities is pretty much in collusion with the wolves. European regulatory bodies are regularly criticised for all manner of shortcomings. But anyone who sees the working of Ofcom as impenetrable and bureaucratic should get a load of the Chinese equivalent.

In 2001, the Chinese government set up the State Council Informatisation Office to monitor development of the growing telecoms sector. But this did not stop criticism of information minister Wu Jichuan, who it was found, according to the *Financial Times*, was too close to the companies he was supposed to be keeping an eye on.

Now an important corner appears to have been turned with the July appointment of Wang Xudong as information minister and

head of a reinvigorated Informatisation Office. His expanded powers are expected to create clarity out of confusion, and rein in some of the maverick tendencies of some operators. He is expected, for example, to clamp down on local units of the major telecoms companies, many of which stand accused of putting competition ahead of customer service. A truly independent regulatory body however is probably some way off.

If China's regulatory framework looks a bit patchy, that's nothing compared with the unevenness of the spread of infrastructure across the country. In short, sophisticated eastern coastal China is an embarrassment of riches, while poor western and northern China is an embarrassment of underinvestment. It's got better recently, but not much.

"When I first got to know the market 10 years ago, there were some regions you simply couldn't get connected to," says Reach's Holt. "The more rural China gets,



CURRENT RULES GOVERNING FOREIGN OWNERSHIP

> **As part** of its entry conditions into the WTO, China's government "restructured" its telecoms industry in 2002.

The new terms meant that foreign mobile network operators were permitted to take an immediate 25% share in Chinese mobile telecoms firms, rising to 49% at the end of 2004. Firms providing internet, paging and other value-added services were allowed to take 30% stakes in Chinese companies, but only in Beijing, Shanghai and Guangzhou, rising to 50% within two years with the lifting of geographical constraints. Tariffs on telecoms equipment are to be phased out and eliminated by 2005.

China draws key distinctions between 'value-added telecom services' and 'basic services'. By basic services it means fixed and mobile telephone and satellite companies, and it's these that it wants to keep licensed and majority state-owned.

The reason is that, next to tobacco, telecoms is China's largest moneyspinner, and it wants to keep control of profits in state hands for as long as it can. There are currently no plans slated to allow majority foreign ownership of the most prized state jewels, fixed-line services. The mobile scene has always been more liberal. ■

the harder connectivity becomes."

Holt says that with its headquarters in Hong Kong, Reach is well positioned, and enjoys good relations with all the main players in mainland China. "The challenge for these companies, and it's a big one, is to move traffic around inside China," he says.

There are drivers at work pushing demand for telecoms westwards, albeit slowly. Holt says: "Companies in China are always looking for low-cost labour. Economic success in one area puts labour costs up, encouraging a push out to more far flung regions." Good connectivity, he says, will follow in their wake.

But it's not just Chinese companies that represent a major wholesale telecoms opportunity. It's the huge range of foreign commercial interests that are currently finding a foothold in this most fecund of markets. "As China continues to attract large corporations looking to do business, demand will be generated for better telecoms capabilities," says Holt.

As Poon says, latency of demand for the whole gamut of services is, if not already there, arriving fast: "As the market opens up, more and more companies want offices there, and they need telecoms services of all kinds."

Infrastructure is more complete and developed on the coast, she says, but with the economy expanding, this trend is starting to expand away from the coast. "The government has been allocating most resources to this coastal region, and a bit inland. They haven't done much with western China, where teledensity is very low."

But Holt warns that prospective network builders who want to steer clear of eastern coastal saturation would do well to consider carefully exactly where their best shot lies in so vast a country. "China has an incredible amount to offer all sorts of companies. But the breadth and width of the place is such that they will need to target where they set up. If they are in financial services, they'll be looking at Beijing and Shanghai. If it's someone like Caterpillar, they'll be looking at locations outside the major cities. Where these companies settle, and in what numbers, will dictate where the networks need to be."

It should be noted here that Hong Kong is politically part of China, but very much its own extremely competitive telecoms market. It's a market that has long since entered the deregulated era and sports a number of fixed-line and mobile players. If mainland China can't rival Hong Kong as a

market, it is certainly its equal in modernity of infrastructure, at least in the all-important eastern coastal region.

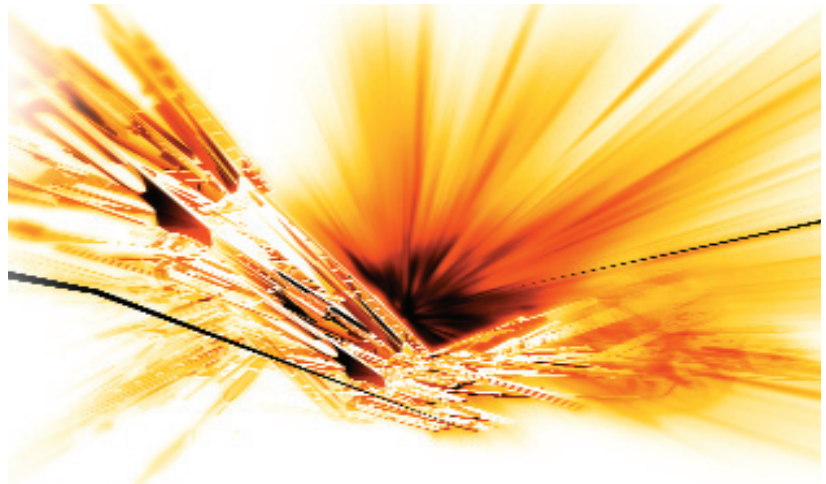
While the regulatory situation may be backward in China, the technology, where it exists at all, is not, with all major players implementing broadband strategies and positioning themselves as IP providers. China's roll-out of high speed internet broadband infrastructure is just beginning and is certainly going to prove a major area of growth for infrastructure suppliers.

China's IP telephony market is arguably the jewel in the country's telecoms crown.

China kicked off its IP odyssey in 1999, when its Ministry of Information Industry (MII) issued licences to government-affiliated telecommunication bodies like China Telecom and China Unicom, and Jitong Communications. This was principally a response to a growing grey market in IP services. But it's burgeoned into the real thing.

Having underestimated the internet's early significance, China was quick to cash in on its commercial potential, although remains ironically suspicious of what its own people are able to access on the web.

By legalising IP telephony, the government effectively took a huge step towards ending China Telecom's international monopoly over long-distance provisioning and has used IP telephony to leverage China's international services market, according to the ITU.



There's also China's high-speed internet undertaking. Coastal China has a broadband, high-speed network designed and built for IP services, linking 15 major cities on the eastern seaboard, including Beijing, Shanghai and Guangzhou.

China Netcom is running the project, which links corporate and government buildings in major cities directly to the IP backbone, providing 2Mbps to 10Mbps connectivity to the desktop. Currently around a third of China's international traffic minutes are carried over IP telephony services.

Come the opening of this great market to outsiders, it's worth noting that entrants will have to compete not only with each other, but with the likely spread of fast-moving, nimble and technically advanced Chinese operators, who will be looking to unlock the potential of China's rural interior

as keenly as outsiders, but armed not only with local knowledge but also with likely covert support from their own government.

Take the example of 3G services, where the Chinese government has already steps to reduce dependence on foreign companies and technology by promoting a homegrown 3G technology called TD-SCDMA, jointly developed by Siemens and state-backed Datang.

Absolutely nobody should underestimate just how major China's potential is, nor what the challenges of unlocking it represent. It is a prospect with few certainties. As a veteran of the market of 10 years, the only future certainty that Reach's Holt is able to vouch for is this: "In 10 years time, anyone who knows China will be hard-pressed to remember the market as it is now." ■

OUTSIDERS AND THEIR VENTURES IN CHINA

> **Impatient with** the speed of the Chinese government's liberalisation of rules on outsiders, lots of western telecoms companies have taken advantage of the chance to partner with, if not own, state-controlled interests.

AT&T, for example, has set up a joint venture with Shanghai Telecom, a subsidiary of China Telecom, called Shanghai Symphony Telecom (SST).

"We were in fact China's first Sino-foreign telecom service joint venture," says Rick Luk, president of SST. "We were created to play a key part in helping China Telecom enter the global telecommunications market and provide world-class broadband IP networking services and solutions."

Equant and China Netcom, China Telecom's biggest indigenous rival, although itself state-controlled, announced a strategic partnership in 2001 to provide global IP and data services for multinational businesses. Through the venture, Equant serves more than 100 customers with 500 connections in China. China Netcom has a number of telecom licences, including the licence to operate international gateways outside of China

Sprint has relations with China Unicom, a wireless service provider, China Telecom, MII and other telecommunications and government organisations in China.

As the Yankee Group's Poon points out: "All these deals are still bilateral. No non-Chinese companies have control of any network."

Not all ventures have ended happily. Asia Global Crossing, not based in China but with an interest in the market, was forced by the bankruptcy of its parent Global Crossing to sell its assets to Asia Netcom, part of China Netcom. The deal was the first purchase of a major telecommunications entity outside of China by a Chinese company. ■