The Telecommunications (Amendment) Bill 2002: "Explanatory Note on the Guidelines on the Competition Analysis of Mergers and Acquisitions in Telecommunications Markets"

Presentation by Stuart Chiron, Director of Regulatory Affairs, PCCW Limited at LegCo Bills Committee Meeting, 27 February 2003

1. Introduction

PCCW welcomes this opportunity to present its views on the Explanatory Note and the Bill. In 2003, the most significant challenges facing Hong Kong's telecommunications sector are how to reduce its cost structure and attract new investment in a very difficult market, and how to avoid falling behind regional competitors. This Bill and any guidelines based on the Explanatory Note will adversely affect the sector's ability to meet these challenges.

Accordingly, PCCW continues to see the Bill as unnecessary (because the current regulatory regime is sufficient to protect users and competition) and counter-productive (because it will increase uncertainty in the market, discourage needed investment and ultimately harm consumers). The content of the Explanatory Note only heightens these concerns. In particular, PCCW urges LegCo to have regard to the following broad points:

1. First, the Government recognises that mergers and acquisitions (M&A) "are part of normal business activities and are economically beneficial to society." Yet, the proposal outlined in the Explanatory Note would prohibit all mergers except the most innocuous ones. The Explanatory Note is fundamentally flawed in both its approach and details.

2. Second, Hong Kong's clear policy preference is for open markets and light-handed regulation, i.e. regulation only where there is demonstrated need for government intervention. Yet, neither the Brief nor the Explanatory Note can

identify problems in the telecoms sector that have occurred in order to justify the imposition of M&A regulation. Nor is there a convincing argument as to why only the telecom sector is being selected for such regulation.

3. Third, a detailed and established regime already exists through license conditions and the Telecom Ordinance which is effective in protecting user interests and competition in the telecom sector. The proposed Bill and Explanatory Note would replace a regime that is transparent, straight-forward and working with an approach that will create substantial problems in attracting investment and facilitating market development. It will certainly be a regime that is imperfect and will bring stakeholders back to LegCo asking why you established such a stifling and unnecessary regime.

If, for whatever reason, LegCo does not wish to follow the recommendation of PCCW and other operators that the Bill and the Explanatory Note be rejected, significant changes need to be made to the Bill. At the same time the unclear and overly conservative Explanatory Note on the proposed merger guidelines requires a substantial re-write.

2. <u>The Need for Primary M&A Review by the Appeal Board</u>

- Effectively, if the Bill is enacted, the TA will be the first and therefore the most important arbiter as to whether an M&A transaction should proceed. This contrasts with other jurisdictions where expert competition agencies and the courts are the arbiters.

- These agencies have considerable competition expertise and resources which are necessary for a proper legal and economic assessment of the anticipated competitive effects of mergers and acquisitions. OFTA does not have the expertise to conduct the required detailed and comprehensive legal and economic analysis.

- In Hong Kong, the Competition Board not surprisingly has greater expertise than OFTA in competition matters. Its membership and focus make it a superior candidate to oversee merger and acquisition activity. Its inclusion in the M&A review process is a very positive feature of this Bill. However, oversight by a single entity is required as speed is of the essence in M&A transactions. M&A transactions are both fragile and time-sensitive. A dual de novo review, while good intentioned, in terms of checks and balances, actually would be counter-productive. PCCW therefore recommends that any M&A review be done by the Competition Board alone. OFTA's input, of course, in this review process, would be welcomed.

3. The Bill must only apply to true "M&A" transactions

- M&A transactions are characterised by a change of control. That is what distinguishes them from other commercial transactions. Yet the Bill would cover any change in the beneficial ownership or voting control of any single voting share in a carrier licensee. This is clearly far too wide. The focus needs to be on change in control not change in ownership. Accordingly, the thresholds should reflect levels consistent with control, something much closer to 50%.

- At the same time, safe harbours need to be established to exclude changes of control which have no practical effect on competition. Other jurisdictions which have merger control, have a threshold based on turnover, assets acquired, or market share.

- In order to ensure the legislation only captures transactions likely to substantially lessen competition, PCCW recommends a market share threshold of 40%, with small market share additions of 5-10% also to be exempt from review.

- There should also be an exclusion in the Bill for internal corporate restructuring within the same group of companies.

4. The Bill must set out an objective test of "substantially lessening competition"

- As currently set out in the Bill and elaborated in the Explanatory Note, the test of "substantially lessening competition" to review M&A proposals is an extremely subjective test and as interpreted by OFTA would prohibit almost every M&A transaction.

- The word substantially is described in OFTA's 1995 Competition Guidelines to mean "big, considerable or significant." The Explanatory Note takes a completely opposite approach. All mergers would likely substantially lessen competition unless they were de minimus. This is not our understanding of LegCo's intent.

- The test therefore needs to be defined in the legislation, the Bill also needs to contain the factors to be considered by the reviewing body, and the guidelines need to be constructed consistent with the detailed legislation and LegCo's intent.

5. The Bill must set out time limits for M&A Reviews

- The current lack of time limits in the Bill could lead to a prolonged period of uncertainty, which would discourage M&A activity and thereafter M&A transactions brought to Government for review. The timelines in the Explanatory Note are too long and do not meet global best practice. As in Australia, US, EU and UK, maximum time limits for both initiating and completing any M&A investigation must be specified in the Bill.

6. Guidelines must proceed the Bill

- The Bill provides for Guidelines to be subsequently adopted by the TA. If Guidelines are to be used, it is essential that LegCo and the public are fully consulted on these Guidelines before the Bill is adopted. We would further suggest that the guidelines be written by the Competition Board. The weaknesses of the Explanatory Note cry out for this Approach. Absent such a consultation, and the establishment of clear guidelines, the market will face greater unpredictability and uncertainty. This would not be a recipe for investment and growth.

- The Explanatory Note is drafted on the basis of flawed reasoning and this will no doubt result in the drafting of flawed guidelines. The Note's pre-occupation with opposing any merger which might potentially raise a competition issue, has produced a proposal that will essentially reject all mergers. This is consistent with OFTA's current view of the "substantially restrict" competition test as reflected in its regulatory decisions and as such should send out a clear alarm to all stakeholders, including users.

- In every way the Explanatory Note reflects an extremely conservative M&A approach, one that is inconsistent with LegCo's goals, global best practices, the needs of the industry and the requirements of users. The Note is clearly anti-merger, the factors used in other markets to evaluate mergers are misapplied, timeframes are lacking or too long, efficiencies and user benefits are essentially ignored, barriers to entry are exaggerated, vertical mergers are presumed to be anti-competitive, failing firms cannot be acquired, safe harbours have been excluded, market share and control percentages are too low producing both uncertainty and intrusive regulation, and considerations which would deter and constrain any anti-competitive action are ignored. In fact, the substance of the Note itself are the best arguments for expanding the legislation and having only the Competition Board review M&A transactions.