TELECOMMUNICATIONS (AMENDMENT) BILL 2002

PCCW LIMITED SUBMISSION TO THE LEGISLATIVE COUNCIL RE "EXPLANATORY NOTE ON THE GUIDELINES ON THE COMPETITION ANALYSIS OF MERGERS AND ACQUISITIONS IN TELECOMMUNICATIONS MARKETS"

INTRODUCTION

PCCW Limited ("**PCCW**") welcomes this opportunity to give the Legislative Council ("**LegCo**") its initial comments on the Administration's "Explanatory Note on the Guidelines on the Competition Analysis of Mergers and Acquisitions in Telecommunications Markets" ("**Explanatory Note**"), and also to reiterate its key ongoing concerns with the *Telecommunications Amendment Bill* 2002 ("**Bill**"), now that PCCW has had a chance to review both the Explanatory Note and the Bill together.

The Explanatory Note suggests that the Bill and the Explanatory Note adopt measures comparable to other jurisdictions, however:

- there are many policy justifications for Hong Kong's regulatory settings being less intrusive than those designed for larger and more diverse economies with a less liberal investment environment than Hong Kong; and

- even if such matters are ignored, and it is assumed that Hong Kong should adopt a similar approach to regulation as Europe and the United States, the procedures and powers proposed in the Bill are in fact more extensive and less clear than those adopted in such jurisdictions.

(a) Objective factors dictate that Hong Kong should not adopt complex and time consuming procedures

Hong Kong already has one of the most competitive telecommunications industries in the world, offering some of the lowest prices to consumers and some of the most advanced services. Barriers to entry are very low in comparison with other telecommunications markets worldwide, for example:

- For its geographic size and population Hong Kong has a very high number of telecommunications operators whether fixed/mobile or network providers/service providers. Following the introduction of full market liberalisation in 2003, the sector is becoming even more competitive.

- The market is highly addressable given the affluence of customers and demographic concentration. Hong Kong is a relatively unique market for telecommunications services. In terms of its size and concentration of population, it is comparable to London and New York rather than United Kingdom or the United States.

- It has a very sophisticated regulatory environment that already full embraces competition regulation, interconnection and number portability and the regulatory powers available to the Telecommunications Authority ("**TA**") to promote competition are already very broad.

Accordingly two particularly important issues should not be lost in a broad comparison with other jurisdictions:

- It is far less likely in Hong Kong that mergers and acquisitions ("**M&A**") will substantially lessen competition given the dynamics of its particular telecommunications market and of its economy generally.

- It is inappropriate for Hong Kong to simply "mimic" merger procedures in the United States and Europe as Hong Kong is a materially less complex market and also one that has historically differentiated itself on the basis of minimal regulatory intervention.

The Government has already rejected the introduction of a general competition law for Hong Kong on the basis that Hong Kong's regulatory environment should differentiate itself from other jurisdictions, for example the Government has made the following statements on this subject in November 1997:

> *We are committed to the promotion of free trade and competition. We also subscribe to the economic philosophy of minimum government intervention in market forces. This is the best formula for enhancing economic efficiency, which is the ultimate, shared objective of our competition and trade policies. The accepted test of whether competition exists is whether the market is accessible and contestable.*[1]
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> *Whilst promoting competition is important, it is a means rather than an end in itself. We do not press for free competition at all cost. Indeed, we often have to strike a balance between the promotion of competition and other government policies and weigh these against what is best for the economy as a whole.*[2]
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> *Compromise free and open trade principles: If the Government were to introduce an all-embracing law to restrict certain forms of business activities across the board, this would risk undermining our free and open trade policy and ultimately our competitiveness. Judging from experience overseas, the extent of anti-trust legislation and related set-ups does* ***not*** *seem to be directly proportionate to the competitiveness of the economy. It is salutary that neither Singapore nor Hong Kong, often quoted as the most competitive economies in the world, has a general competition law. This is because free market forces have been allowed to operate in both.*[3]

In this context it is also relevant to note the TA's comments in 1997 to the Economic Services Panel of the Provisional Legislative Council in respect of the decision to approve the acquisition of Pacific Link Communications Limited by Hongkong Telecom CSL Limited:

> *"Another important issue in the regulatory framework is that we have created a free market economy in the telecommunications sector in Hong Kong. We allow foreign investors to freely enter into this market in Hong Kong. We must also allow foreign investors to freely exit the market if they want to do so because of commercial reasons. Prohibition of the transfer*

[1] See Government Response to Consumer Council's Report Entitled "Competition Policy: The Key to Hong Kong's Future Economic Success" – November 1997, para 2.7
[2] Ibid, para 2.13.
[3] Ibid, para 5.5(d).

of assets, including licensing rights, should only be considered in extreme cases where the public interest is significantly undermined.”[4]

In late 1997, when the Government rejected the introduction of a general competition law for Hong Kong and the TA approved the acquisition of Pacific Link Communications, the telecommunications sector had only enjoyed 2 years of liberalisation. In 2003, Hong Kong's telecommunications sector is one of the most competitive in the world and significantly more competitive than many other sectors of the Hong Kong economy that remain entirely unregulated. Accordingly, in the absence of any M&A regulatory powers of the type now being proposed, the Hong Kong telecommunications sector developed from a monopoly to the current very competitive market. 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 difficult market and to avoid falling behind regional competitors such as Singapore.

Yet, despite this, in 2003, the administration is proposing sweeping new M&A regulatory powers and also to benchmark itself against the “high water mark” of regulatory scrutiny and complex administrative process as adopted for the most complex mergers in much larger and more diverse economies such as the United States and the European Union. Such a step undermines the very uniqueness of Hong Kong's regulatory environment and is simply unnecessary and unjustifiable for Hong Kong at this stage when the market is fully open and competitive.

In these circumstances, Hong Kong's telecommunications operators are rightly concerned about the potential for such M&A regulations to result in a significant “regulatory failure” in the telecommunications sector. Further, this potential for regulatory failure is being introduced at the very time when there is evident need for appropriate degrees of rationalisation within the industry to make it more efficient. Further, this proposal also comes at a time when it is extraordinarily difficult for telecommunications operators to raise new capital and pursue new business models. Therefore, at this particular juncture the impact of any regulatory failure in applying these new rules is potentially very significant.

In the circumstances LegCo should query why this initiative is required at all.

(b) The TA's proposed M&A powers are more intrusive than other jurisdictions

It is not correct to suggest that the regulatory model proposed by the Bill and the Explanatory Note are comparable with those of other jurisdictions, for example:

- Typically the decisions of the relevant competition regulator in relation to mergers and acquisition transactions are not made “in the opinion” of that regulator (as is proposed in the Bill). Rather, an objective test is set which is open to review before the courts.

- The “change in control” definitions in the Bill are extremely broad and include the transfer of even a single share or a change in a single director. As defined, they do not refer to a true “change in control” and are in fact much broader.

- Certain other countries have sought to clarify the criteria to be taken into account in determining whether a “substantial lessening of competition” will occur. Other

[4] TA, *Paper for the Economic Services Panel Provisional Legislative Council: The Impact on the Development of the Telecommunications Industry in Hong Kong in light of the Acquisition of Pacific Link by Hongkong Telecom* (29 December 1997), para 26.

countries all have an established body of case law and decisions which clarify the meaning of this term. No such clarity exists in Hong Kong.

- In most other countries to which the Office of the Telecommunications Authority ("**OFTA**") refers there is a separation between the telecommunications sectoral specific regulator that regulates the telecommunications sector and the competition regulator that reviews merger and acquisitions proposals. In Hong Kong there will be no such separation of functions.

- The competition regulators in other countries that assess mergers and acquisitions are usually comprised of a commission made up of a number of individuals who are specialists drawn from a variety of relevant disciplines and decisions therefore reflect both a diversity of views and skills. In Hong Kong decisions will be taken by a single empowered individual.

- The relevant competition regulator in other countries are highly skilled and well resourced with a specialist staff of economists and lawyers that are focused entirely on assessing mergers and acquisitions proposals across the entire economy. The TA will not have equivalent resources.

- Other jurisdictions seek to avoid any scrutiny of de minimis mergers and acquisitions activity by excluding most transactions on the basis of the value of the merger or the turnover of the entities concerned. In Hong Kong the regulatory net has been designed to capture all transactions and does not provide for relevant safe harbours.

- Many of the other international regulators work to much faster time scales in approving mergers than the timetables proposed by OFTA.

Accordingly, it is not correct that the Bill and the Explanatory Note reflect international best practice.

(c) The current Bill simply re-packages the original flawed proposal

As proposed in the initial draft of the Bill, the TA was to be provided with the ability to approve shareholding transactions at various threshold levels (i.e. 15%, 35% and 50%) without any competition test being attached to the exercise of those powers. That draft of the Bill sought complete discretion to prevent particular share transfers without any criteria for assessing the TA's regulatory decision. In view of the response of the telecommunications industry, the Bill was redrafted so that the relevant powers of the TA could only be exercised where, in his "opinion", a "change in control" would "substantially lessen competition".

However, in the current draft of the Bill the definition of "change in control" is so broad as to be almost irrelevant (including a single share transfer or change in director). Little guidance has been given regarding what would comprise a "substantial lessening of competition". While the TA has published the Explanatory Note, there has been significant resistance by OFTA to finalising the accompanying merger guidelines prior to LegCo being asked to approve the Bill.

Accordingly, the absolute discretion of the first draft of the Bill has been replaced with a subjectively assessed competition test which, while it is used in certain other jurisdictions which have had many years of experience and court precedent in refining that test, is relatively unknown in Hong Kong. LegCo, consumers, telecommunications operators and investors are no closer to understanding how this power may be exercised that they were in respect of the original proposal.

Therefore, LegCo may justifiably ask whether the revised Bill is in fact more extensive than the original Bill, which was rejected. It is simply a case of "old wine in a new bottle".

(d) LegCo should reject or reformulate the Bill

PCCW submits that the Bill should be rejected in its entirety. Section 1 of this submission further highlights the reasons why PCCW continues to believe that this is the only appropriate action for LegCo to take.

If, in spite of the above considerations, LegCo decides to push ahead with sector specific M&A regulation, some fundamental changes need to be made to the Bill, which in its current form is defective and unduly intrusive. As clearly demonstrated by the Explanatory Note, LegCo cannot afford to simply leave these matters to the discretion of OFTA.

Section 2 of this submission sets out the key necessary changes that PCCW considers must be made to the Bill, which are in summary as follows:

- Only the Telecommunications (Competition Provisions) Appeal Board ("**Competition Board**") should have the power to review mergers and acquisition proposals and exercise any consequent powers.

- The relevant test should be applied objectively, not simply "in the opinion" of the regulator.

- The relevant test should be tightly defined so that it only applies to true "changes of control" where a different entity is able to control the decisions of the carrier after the acquisition.

- Such a change in control must be one that clearly substantially lessens competition.

- The "substantial lessening of competition" test must also be properly defined, in the legislation.

(e) The merger guidelines must be finalised before the Bill is passed

Although PCCW is disappointed that the Explanatory Note is extremely vague and does not represent functional merger guidelines, Section 3 sets out some key concerns that PCCW has with the Explanatory Note and would have with any merger guidelines based on the Explanatory Note. The key issues in respect of which LegCo must satisfy itself are:

- that, following appropriate input from all relevant parties including the Competition Board, all relevant issues have been adequately addressed in the proposed guidelines before any M&A Bill is passed; and

- that the guidelines do not inappropriately prevent beneficial and pro-competitive M&A transactions.

1. THE BILL IS UNECESSARY AND COUNTER-PRODUCTIVE

After carefully reviewing the Explanatory Note, PCCW remains of the view that the Bill itself is both (1) unnecessary and (2) counter-productive. As the Bill now stands, it will increase uncertainty in the market, discourage investment and ultimately harm the industry and end-users. This is explained further below.

(a) The Bill is unjustified, and fundamentally inconsistent with the Government's approach of "light-handed regulation"

The Bill fails to reflect the stated aim of supporting open markets and light-handed regulation. Rules governing competition in the telecommunications sector already exist through licence conditions and the *Telecommunications Ordinance*. No problems have been identified with these rules to justify the imposition of additional merger and acquisition ("**M&A**") regulation. Neither OFTA nor the Government can point to a real problem that needs to be addressed or a recent case that justifies this legislation. One is tempted to remind policy makers who supposedly support light-handed regulation of the adage: "*If it ain't broke, don't fix it*."

PCCW submits that the potential for a "regulatory failure" to occur in the application of these new powers is in all likelihood greater than any potential disadvantages of M&A activity. The Bill will create a complex, time consuming, and largely unnecessary procedure which, once established, will create an administrative process that will be self perpetuating and inconsistent with Hong Kong's open economy.

Two of the ITBB objectives in introducing the Bill are <u>predictability and speed</u>. In reality, neither of these objectives will be achieved under this Bill and any merger guidelines based on the Explanatory Note. The proposed Bill will in fact replace the current well understood and effective regulatory regime with one that increases the subjective power of a sectoral regulator with little substantive competition law experience. Predictability will decrease just at the time when the market requires the opposite environment. The proposed review process of two de novo steps, one by OFTA and the other by the Competition Board, will not produce speedy administrative decisions and cannot be viewed as light handed.

In 1997, when Hong Kong Telecom CSL Ltd acquired Pacific Link Limited, the aggregate market shares of the two companies in the mobile sector, comprised approximately 45%. In that case, the relevant license conditions of the two carriers gave the TA the power to approve the relevant share transfer. A submission process did take place and the TA reviewed the proposed merger and it was approved in 3 weeks. The market share of the post merger entity was quickly reduced by competition to below 25% and it soon was no longer even the market leader. It was an entirely correct decision to approve the merger and to do so quickly. Yet if the same decision were to occur in the current market (which is vastly more competitive), after the introduction of the Bill, the TA would undoubtedly undertake a five to seven months review process and in all likelihood the merger would not have been cleared. In this respect, Hong Kong is taking a step backwards by increasing levels of regulatory intervention in an already highly competitive market.

When considering the justifications for the Bill put forward by the administration, LegCo should have regard to the warnings of economists about the dangers of giving inappropriate responsibilities to sector specific regulators. In particular, PCCW notes the comments of Professor Henry Ergas that:

> *"Regulators with responsibility for only one industry sector are more likely to place pressure upon legislators to preserve regulation of any particular activity than regulators with responsibility for the economic regulation of several sectors, all other things being the same…Thus, regulators who have built careers in the former situation are likely to invest considerable effort and resources into lobbying legislators to help preserve their positions and salaries, even when the economic justification for their continued role no longer exists…Should sector-specific regulators succeed in their efforts to preserve their own 'empires' (that is, to perpetuate regulation when it is no longer needed), this has adverse effects on*

economic efficiency, as regulation in the absence of clear market failure is obviously inefficient."[5]

(b) Sector specific merger regulation is out of line with global best practice

There is no justification for a proposal to regulate only mergers and acquisitions in the telecommunications sector, which is not unique in its structure to other sectors that remain unregulated in this regard. It is also inappropriate to be introducing disincentives to investment through additional unpredictability and uncertainties in a sector that has been particularly hard hit by the economic downturn.

This is not the approach taken in the US, UK, EU or Australia. It is notable in this respect that in the EU, the European Commission ("**EC**") has recently released a Recommendation which seeks to roll back ex ante sector specific regulation where it is no longer required so as to provide greater legal certainty for suppliers of communications networks and services.[6], Speaking on the Recommendation, ECCommissioner Mario Monti has noted:

> "*Sector Specific regulation should be the exception, antitrust rules should be the norm. For an operator, being subject to ex ante regulation is a heavy burden because it limits its commercial freedom without any evidence of abuse having occurred*."

A sector-by sector approach is simply not justifiable as good public policy, economics or law. Any proposal for M&A regulation should be of general application to all industrial sectors, administered by a competition authority, and discussed in the context of whether general competition legislation should be introduced in Hong Kong.

2. IF THERE IS TO BE SECTOR SPECIFIC MERGER REGULATION IN HONG KONG, SOME FUNDAMENTAL CHANGES MUST BE MADE TO THE BILL

(a) The primary merger review body should be the Competition Board, not OFTA

In Hong Kong, the Competition Board 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, as addressed in more detail below, 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, actually would be counter-productive. PCCW therefore recommends that any M&A review be done by the Competition Board. OFTA's input, of course, in this review process, would be both valuable and welcomed.

(i) Merger review is generally conducted by competition not sector specific regulators

M&A regulation presents complex economic and legal issues. Such regulation should not be left in the hands of a sector specific regulator without the resources or expertise to do it efficiently or effectively. For this reason in the US, it is the Department of Justice ("**DoJ**") and the Federal Trade Commission ("**FTC**"), and not the Federal Communications Commission that looks at telecommunications mergers and acquisitions. In the EU, it is

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[5] LC Paper No. CB(1)963/02-03(04), Appendix – Opinion of Professor Henry Ergas: "The importance of economy-wide competition law for Hong Kong", p. 3.

[6] See Recommendation of 11/02/2003 on Relevant Product and Service Markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC.

DGIV and not DGXIII; in the UK it is the Office of Fair Trading ("**OFT**"), the Competition Commission ("**CC**") and the Secretary of State for Trade and Industry, and not Oftel.

Global best practice indicates that specialised competition agencies and the courts, not sector specific regulators, should be the "judges" in these matters. For example, the OECD notes that:

> *"Compared with sector-specific regulators, competition agencies seem better suited by their accumulated expertise, experience and basic institutional characteristics ("institutional culture") to protect competition from anti-competitive behaviour and mergers"*[7]

The Competition Board has certain advantages over OFTA in this regard. First, it is structurally separate from OFTA, which is engaged in the day to day regulation of the telecommunications sector and is constantly lobbied by the industry. Secondly, it reflects a diversity of views as it has a number of members. Thirdly, that diversity of views reflects a diversity of expertise regarding legal, economic and consumer affairs.

(ii) Primary review by the Competition Board creates better checks and balances

According to the administration, the Bill incorporates sufficient checks and balances, and is in keeping with overseas practice:

> *"Aggrieved licensees can appeal to the Telecommunications (Competition Provisions) Appeal Board. The TA's decisions may also be challenged through judicial review. We have built in sufficient checks and balances….Like the TA in Hong Kong, the European Commission…has the power to investigate as well as to prohibit mergers and order divestiture"*[8]

Considering the above reference to the powers of the EC to investigate as well as prohibit mergers, it important to note that the EU Competition Directorate (DGIV) is separate from its telecom directorate (DGXIII).

Further, it is important to note that DGIV has competition law experience, and has recently announced a series of measures that it intends to take to reform its merger clearance procedures. The reforms include the creation of "peer review panels" composed of experienced officials, who will review the investigating case team's conclusions with a "fresh pair of eyes" at key points in each merger inquiry.[9] The introduction of such "peer review panels" is designed to address recent harsh criticism the Competition Directorate has received for acting as both "judge and jury" in investigating and evaluating the merger submissions and then making the final administrative decision on whether a merger will be allowed to proceed. Along similar lines, in the UK, one of the key reforms put in place by the enactment of the *Enterprise Act* is to replace the single Director General of Fair Trading (upon whose advice the Secretary of State makes merger control decisions) with a new body - the Office of Fair Trading – which is to be headed by a Board rather than by one person.

The current right of appeal to the Competition Board does not provide a sufficient check on the TA's powers, since it would (at best) cause delay to the completion of many mergers and acquisitions and (at worst) cause them to be abandoned. Nor does this appeal right change the primary role played by OFTA as initial judge, jury and prosecutor.

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[7] OECD, *Relationship between Regulators and Competition Authorities* (June 1999), p. 8.
[8] LC Paper No. CB(1)187/02-03(01): pp 1-2.
[9] See: "Commission adopts comprehensive reform of EU merger control" European Commission Press Release IP/02/1856 of 11 December 2002

Giving the Competition Board primary jurisdiction to review M&A transactions and reducing the role played by the TA in such decisions would create a much better system of checks and balances.

(iv) The Competition Board is better resourced than OFTA to review mergers

In other jurisdictions that choose to regulate mergers and acquisitions, decisions are taken by an agency with considerable competition expertise and resources, which are necessary for a proper legal and economic assessment of the competitive effects of mergers and acquisitions. These agencies cover all markets and act within commercially realistic timeframes. By way of example:

- In the US, the DoJ has around 30 to 40 paralegals on staff at any one time, who review documents, set up interviews, take notes at interviews, do data entry and Internet research. Senior career paralegals often act as case managers for cases going to trial. In addition, DoJ employs about 50 economists and a larger number of lawyers.[10] US Merger review by the FTC is conducted by four operating divisions with 20 to 30 attorneys in each. For a major file, during the initial 30-day review period, there might be a lead attorney, one or two junior attorneys and an economist. After the second request, additional staff may be assigned. For complex cases that are litigated, there can be as many as eight attorneys and two economists. The FTC also makes extensive use of paralegals, of which there about 30 on staff at any given time[11]

- In the UK, OFT's Mergers Secretariat comprises administrative, legal, economic and accountancy staff (6 economists, 6 support staff, and 13 case officers as of December 1999). The Office has its own internal legal division, and two lawyers are specifically responsible for advising whether a proposed transaction qualifies for investigation under the *Fair Trading Act*.[12]

- In Australia, the ACCC has approximately 20 to 23 staff devoted to merger review.[13]

In other jurisdictions, decisions on mergers and acquisitions are not taken by individual sectoral regulators with insufficient expertise and resources to conduct such assessments within commercially realistic timeframes. OFTA does not have the expertise to conduct the detailed and comprehensive legal and economic analysis required and has indicated that it will not be adding any specialized legal or economic staff to do so.

The dangers of the current proposal are therefore that either defective decisions will be made (the TA having too little expertise or erring on the side of caution in prohibiting the transaction in the case of doubt), or that the assessment will take so long that the economic benefits to be gained from the transaction – even if it is ultimately approved – will be lost through uncertainty and delay. Quality decisions based on proper analysis must be taken at the outset.

One option for dealing with these concerns would be to establish a separate body or board for reviewing mergers and acquisitions, with associated additional staff and resources. However, in PCCW's view, this may be a costly and duplicative solution. Given the establishment of the Competition Board (with members with significant economic and legal training), a preferable option would be to give this body powers to review mergers and acquisitions, and

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[10] Canadian Competition Bureau, *Merger Review Benchmarking Report* (28 June 2001), p. 74.
[11] Ibid, pp. 64-65.
[12] Ibid, p. 45.
[13] Ibid, p. 83.

to give this body primary jurisdiction over such proposals. In addition, there would need to be legislative amendments to ensure that the Competition Board has the necessary powers, such as the power to take interim measures pending its final decision.

(b) The Bill must contain a clear definition of what is regarded as a "merger" or "acquisition"

In PCCW's submission there should be a two part test and it should be applied objectively, not subjectively (i.e. not "in the opinion" of the TA):

- First, a "change of control" must have occurred, meaning that a different entity is truly in a position to control the material decisions of the corporation.

- Secondly, that change in control must be one that will "substantially lessen competition", which should be defined relatively narrowly and clearly.

What distinguishes M&A from other transactions is a change in ownership that results in a change in control. Other jurisdictions with M&A regulations use the concepts of control or decisive influence as the test for the definition of a merger or acquisition for that purpose (although in some cases there may be a presumption of control when a majority shareholding is obtained).[14]

It is presumably for this reason that the OFTA Consultation Paper on Regulation of Mergers and Acquisitions in the Telecommunications Market issued on 17 April 2001 ("**Consultation Paper**") originally proposed shareholding thresholds as triggers for regulatory intervention ranging from 15% to 50%. A 15% threshold was proposed by reference to European precedents as the level representing a significant minority interest at which one might be able to assume a level of influence. A 35% threshold was proposed as it correlated with the figure recognized by the Codes on Takeovers and Mergers and Share Repurchases in Hong Kong as representing a significant change in control which triggers the mandatory requirements for listed companies. A 50% threshold was also proposed as being the threshold which "*will in the ordinary sense represent majority control*."[15]

In contrast to the proposals in the Consultation Paper, the Bill currently covers any change in ownership in the beneficial ownership or voting control of any single voting share in a carrier licensee. As has been already noted by certain LegCo members at the Bills Committee meetings discussing the Bill, this is clearly far too wide. No explanation for this overly wide approach has been clearly articulated by OFTA.

Controlling share transfer transactions in the way proposed is clearly unnecessary and will have a chilling effect on investment in Hong Kong. It is also inconsistent with Hong Kong's reputation as a free economy and the Government's stated objectives. The fall in share values in the technology and telecommunications sectors is well known – the Bill is likely to make it even more difficult for companies to raise funds on the capital markets. The Explanatory Note mentions exemptions for share transactions made purely for investment purposes – but it is by no means clear that these exemptions would be wide enough to avoid the adverse effects mentioned above. It is equally of no assistance from a business certainty perspective to note that of the vast range of transactions potentially caught by the Bill, it is only those which happen to be regarded by the TA as lessening competition that will actually be investigated.

Section 7P(1)(b), which refers to any change in the beneficial ownership of the voting shares of a carrier licensee, results in a large range of innocuous corporate transactions being

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[14] See for example the Canadian *Competition Act*, s 91.
[15] OFTA, Consultation Paper, para 14.

potentially subject to merger review under the Bill. This is unnecessary, unacceptable from a business certainty perspective and also likely to divert the attention and scarce resources of the reviewing body away from more critical transactions. Section 7P(1)(c) is also extremely broad, and is unnecessary since section 7P(1)(a) already covers any change in control. The Bill needs to focus on the critical issue of change of control. All else promotes uncertainty, wastes resources, and is counter-productive.

The definition of "change of control" in 7P(12) is itself also too broad. Becoming a director or principal officer, the beneficial owner of 15% or more of the voting shares of a licensee, or the voting controller of more than 15% of the voting shares would not, (contrary to the implication of this section), give a person the power to "*ensure that the affairs of the licensee are conducted in accordance with the wishes of that person*." Since it appears intended that this is the real test, subsection 12(d) is a sufficient definition of control and subsections (a), (b) and (c) should be deleted in the interests of clarity and avoiding over regulation. In consequence of proposed section 7P(1)(c) recommended above, proposed sections 7P(13) and 7P(14) should be deleted. Again, the Bill needs to focus on change of control.

In order to better gauge the impact of these provisions as they are currently drafted in the Bill, PCCW notes that the Honourable Ms Emily Lau requested at the Bills Committee meeting on 3 December 2002, that the administration give an estimate as to exactly <u>how many</u> transactions per year they considered would be potentially caught by the Bill. PCCW considers that this would be a very fruitful exercise in order for LegCo to properly understand just how broad and unacceptable the current drafting of the Bill is. It would be similarly useful for OFTA to demonstrate how it would have dealt (under the Bill and its Explanatory Note) with previous M&A cases both in Hong Kong and outside of Hong Kong. This would provide interested parties useable examples as to how to approach M&A transactions in Hong Kong. It would also give OFTA an opportunity to demonstrate its expertise.

<u>(c) The Bill must contain a clear and objective definition of which M&A transactions will be reviewed</u>

(i) There must be statutory safe harbours

The TA should not have the power to investigate any change of control – a "safe harbour" needs to be provided in the Bill to exclude changes of control which have no practical effect on competition – for example because of the low value of the transaction or small market share of the parties involved. Other jurisdictions that have merger control have a threshold based on turnover, assets acquired, or market share. In the UK, the competition authority has no power to examine a merger or acquisition unless either a certain market share would be achieved or increased by the merger, or the assets of the "target" company exceed a certain level. Taiwan uses a market share test. The US uses a "size of party" or "size of transaction " test. The EU uses a turnover test.

As currently drafted, the Bill empowers the TA to potentially investigate <u>any</u> change of control, irrespective of the turnover of the parties, the assets to be acquired, or the market share of the parties concerned. This is neither in the interests of business certainty or efficient regulation in the interests of competition.

There is also no exclusion in the Bill for internal corporate restructuring within the same group of companies, where control of a company within the group is not shared with or transferred to third parties outside the group. Such transactions should not be the subject of M&A regulation and should be expressly excluded.

(ii) The Bill must contain a definition of "substantial lessening of competition"

In any merger control regime, it is important that the test for granting approval or prohibiting the transaction (as well as for seeking approval) be reasonable, consistent with global best practices, and as transparent as possible, so that the parties can predict the regulatory results/risks with some degree of certainty. This is particularly important in regimes where there is no compulsory pre-notification requirement and parties have to make their own assessment of the regulatory risk involved in the transaction. It is also important in small markets, such as Hong Kong, which are generally more concentrated than other jurisdictions such as the EU, US and UK that the test for prohibiting transactions is not set at too low a level.

Clear and reasonable thresholds for regulatory intervention would also decrease the administrative burden on the reviewing body, and ensure that its attention and resources were appropriately focused on those transactions most likely to be of concern.

The range of transactions that would be subject to potential investigation under the undefined and subjective "substantial lessening of competition" test in the Bill goes far beyond those that might give rise to competition concerns. The weight given to the subjective opinion of the TA and the lack of any statutory indication as to what will be regarded as a "substantial lessening of competition" (or at least the specification of concentration levels which are regarded as <u>not</u> being of any concern in this regard) is also completely unresponsive to valid business and consumer concerns.

The administration has claimed that:

> "*We will set out clearly in the guidelines what constitutes "substantially lessening competition" in a telecom market. This will give clear guidance to the industry and investors*."[16]

The resulting "certainty" given to operators, as set out in the Explanatory Note, is that any M&A transaction will likely be regarded as "substantially lessening competition" unless it has "*barely any discernible effects on the competitive process*."[17] This is clearly an unacceptable approach, as it would likely block all but the most innocuous transactions, and is inconsistent with global practices. It is inappropriate to define the "substantiality" test as anything beyond that which is de minimus. This is a unique and dangerous approach, and one which ignores the fact that transactions may have varied effects on competition, investment, innovation and user benefits.

It is accordingly clear that merger guidelines (particularly those in the form of the Explanatory Note) are insufficient to deal with this issue, and that an objective "substantially lessening competition" needs to be defined in the Bill itself. In addition, the Bill needs to set out minimum concentration levels below which M&A transactions will <u>not</u> be regulated.

In this regard, PCCW submits that the concentration levels should be aimed at catching for review only those transactions likely to result in the creation of <u>significant</u> market power, or dominance. That is, it must be made clear in the Bill that "substantial" means "big, considerable or significant" (consistent with the TA's 1995 *Guidelines to Assist the Interpretation and Application of the Competition provisions of the FTNS licence*) and not merely anything of interest or worthy of consideration. Such an approach would be consistent with international practice[18], appropriate considering the relatively small size of the Hong

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[16] LC Paper No. CB(1)187/02-03(01): p. 17.
[17] Explanatory Note, para 21.
[18] E.g. the thresholds adopted in the EU.

Kong economy, and also align with the original aim of the Bill, which was to prevent the level of competition in telecommunications markets from being "significantly diminished by mergers acquisitions".[19]

Clearly, concentration levels of 15%, are not likely to result in the creation of significant market power or dominance. It would be more practical to clearly signal that M&A transactions creating market shares below 40% would not be subject to review. As noted by the World Bank:

> *"Market dominance is a more extreme form of market power. The definition of market dominance varies significantly in the laws and jurisprudence of different countries. In general, however, two factors are key in the determination of market dominance. First there must usually be a relatively high market share (usually no less than 35%, often 50% or more). Second, there must normally be significant barriers to entry into the relevant markets occupied by the dominant firm."*[20]

Where one of the merging parties already has a degree of market power, regard should also be had to the level of increase in this market power that is likely to result from the transaction. When a firm has a degree of market power, it is not necessarily the case that every given mergers and acquisition will enhance that power or substantially lessen competition. Whether there is a substantial lessening of competition is the question to be assessed by the merger investigation. Currently, the Explanatory Note appears to wrongly suggest that any firm that is "*not subject to sufficient constraint from its competitors and customers*" cannot be party to an M&A transaction (particularly a horizontal one). This overlooks a variety of pro-merger benefits, and is inconsistent with overseas practice, for example, the US *Horizontal Merger Guidelines*, which provide that:

> *"A merger is unlikely to create or enhance market power or to facilitate its exercise unless it significantly increases concentration and results in a concentrated market, properly defined and measured. Mergers that either do not significantly increase concentration or do not result in a concentrated market ordinarily require no further analysis."*[21]

Accordingly, a safe harbour for small additions (e.g. 5-10%) to market shares should be permitted without review or a presumption created that such transactions would not substantially lessen competition.

(iii) The Bill should contain factors to be considered by the reviewing body

The Legislative Council Brief to the Bill notes that a key aim of the Bill is to "*provide a comprehensive and clear regulatory framework on mergers and acquisitions for the telecommunications business sector.*"[22] The current proposal to regulate only those transactions which result in a "substantial lessening of competition", as elaborated in the Explanatory Note, patently fails to achieve this aim.

One solution for giving business and the regulator a better indication of the legislative intent behind M&A regulations, which has been adopted in overseas jurisdictions (e.g. Australia[23], Canada[24] and the EU[25]), is to set out in the legislation key factors that the reviewing body is required to take into consideration when evaluating M&A transactions.

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[19] See OFTA, Consultation Paper, para 2.

[20] World Bank, *Telecommunications Regulation Handbook* (November 2000), para 5.2.3.

[21] DoJ and FTC, *Horizontal Merger Guidelines* (2 April 1992, revised 8 April 1997), p. 4.

[22] ITBB CR 7/13/14(02) Pt.3, para 5.

[23] See section 50(3) of the *Trade Practices Act* 1974.

[24] See section 93 of the *Competition Act*.

PCCW considers that it is absolutely critical for LegCo to include such factors in the Bill (and not merely leave them to the discretion of the regulator in the guidelines), to help ensure that the regulating body makes appropriate decisions on M&A transactions based on a consideration of all relevant factors, and also to give much needed better certainty to the telecommunications industry as to what will be involved in an M&A review. This approach would also be consistent with that adopted in relation to the application of several of the other key provisions of the *Telecommunications Ordinance* regulating anti-competitive conduct (e.g. sections 7K(2) and 7L(3)).

(d) The Bill must contain statutory timeframes for merger reviews and set out the basic procedure for a merger review

(i) Statutory timeframes

> *"It is clear that a very critical part of the merger review process is identifying, as quickly as possible, those files with which the Bureau has no or relatively minor concerns…The issue of timeliness is one of the most important to stakeholders."*[26]

M&A activities are extremely fragile and extremely time-sensitive. The underlying drivers of value upon which the price of acquisition or merger is based (e.g. the buyer or seller's share price) are rarely constant for periods of months. They cannot survive the uncertainty and time involved in a double merit review process. A lack of strict deadlines and the real possibility of lengthy review periods by the TA and then the Competition Board currently provided for in the Bill may prove fatal to a high percentage of telecommunications M&A transactions in Hong Kong. This would deny users the benefits of M&A transactions.

In particular, PCCW is concerned that the proposed amendment to section 32N in the Bill such that an appeal to the Competition Board will automatically suspend the operation of a TA direction under 7P(1) or a decision of the TA under proposed section 7P(6)(a) or (b)(i) or (ii), will mean that merger clearance decisions (which the LegCo Brief to the Bill notes are normally sought on advice from merchant banks, accountants and lawyers seeking regulatory certainty)[27] are automatically suspended for <u>indefinite</u> periods of time while the Competition Board conducts its review. Of course, the opposite procedure is equally unattractive. A M&A transaction could proceed and then could be required to be unwound. The problem is not the automatic stay power but the double de novo review process.[28]

Eliminating the uncertainty and potential delay involved in double merits review by having the Competition Board review all mergers at the first instance will go some way towards alleviating these concerns. However, even if the Competition Board is to be the primary body reviewing mergers, it should be required to do so in accordance with <u>statutory</u> time limits which clearly set out (1) a "no back-stop" date after which objections to transactions may no longer be raised and (2) timeframes for the completion of investigations.

Merger guidelines are intended to operate as practical guidelines, and there is no guarantee that the timeframes currently proposed in the Explanatory Note will be strictly followed. In fact, at the Bills Committee meeting on 3 December 2002, the administration made it clear that they did not regard the indicative time frames to be included in the merger guidelines as

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[25] See Article 2 of *Council Regulation (EEC) No 4064/89 of 21 December 1989 on the control of concentrations between undertakings*.
[26] Canadian Competition Bureau, *Merger Review Benchmarking Report* (28 June 2001), p. 91.
[27] ITBB CR 7/13/14(02) Pt.3, para 4.
[28] PCCW does, however, believe that entities such as the Competition Board should have relatively broad discretionary powers, including the clear power to grant discretionary stays. A clarification of Section 32N would be useful in that respect.

rigid requirements, and demonstrated a clear reluctance to be pinned down to fixed time frames. Such uncertainty is not acceptable commercially, nor in line with global best practice. In failing to provide statutory timeframes for the conduct of merger reviews, the Bill is out of line with the *Enterprise Act* in the UK; *Council Regulation 4064/89 of 21 December 1989 on the Control of Concentrations Between Undertakings* in the EU; the *Clayton Act* in the US and the *Competition Act* in Canada.

Despite the claim in the Explanatory Note that the indicative maximum periods of seven months for the TA to make a decision on a transaction under section 7P(1) and five months to consider an application for consent under section 7P(5) are "*comparable to those adopted by overseas jurisdictions*", PCCW is also concerned that the proposed time limits in fact fall well below global best practice. By way of illustration, PCCW notes that:

- In Australia, the *Merger Guidelines* provide that the ACCC should generally be able to provide informal merger clearances (where the ACCC is unable to make market inquiries) within two to three weeks; formal clearances within 10 to 15 days where the ACCC is satisfied that the matter does not breach the merger thresholds and within about 1 month in matters which do appear to breach the merger thresholds, except in "those few major cases which raise very substantial issues" in which case the ACCC may take six to eight weeks to consider the matter.[29]
- In the US, the *Clayton Act* stipulates that parties must generally wait 30 days before completing a transaction required to be notified to the FTC and DoJ, which period is reduced to 15 days in the case of a cash tender offer or a bankruptcy sale. If either agency determines during the waiting period that further inquiry is necessary, it may issue a "second request", which extends the waiting period for a specified period, usually another 30 days (10 days in the case of a cash tender offer or bankruptcy sale), after all parties have complied with the second request.[30]
- The Singapore *Code of Practice for Competition in the Provision of Telecommunication Services* provides that the IDA will ordinarily issue merger decisions within 30 days, which period is extendable by up to 90 days in the case of a proposed consolidation that raises novel or complex issues[31].
- The maximum statutory time limits for the European Commission ("**EC**") to make decisions on the range of mergers which come before it for review are two months shorter than the seven month maximum period proposed in the Explanatory Note in respect of investigations under section 7P(1).
- In the UK, the Office of Fair Trading ("**OFT**") has stated that, in practice, it will aim to complete its investigations within shorter timetables than those provided under the *Enterprise Act*.[32] The administrative timetables currently adopted by OFT and DTI (in respect of merger decisions under the *Fair Trading Act*) provide that, in most cases, a decision on reference to the Competition Commission ("**CC**") of a public merger will be made within 45 working days of receipt by OFT of a satisfactorily complete submission. OFT generally provides informal merger clearances within the same timeframe.[33] In addition, for urgent cases, the *Enterprise Act* provides for merging parties to send OFT a "merger notice", in which case OFT will usually have to complete its investigation within 20 working days, subject to extensions in some cases.[34] Currently, the *Fair Trading Act* provides for a voluntary prenotification procedure, which makes provision for a proposed

[29] ACCC, *Merger Guidelines* (June 1999) para 4.14.
[30] See FTC, *Introductory Guide I to the Premerger Notification Program: What is the Premerger Notification Program*? (Revised January 2002).
[31] IDA, *Code of Practice for Competition in the Provision of Telecommunication Services* cl 9.4.
[32] OFT, *Overview of the Enterprise Act: The Competition and Consumer Provisions*, p. 11.
[33] OFT. *Mergers: A guide to procedures under the Fair Trading Act 1973*, pp. 16, 21.
[34] OFT, *Overview of the Enterprise Act: The Competition and Consumer Provisions*, p. 11.

merger to be considered by OFT within 20 working days, with a maximum extension of 15 working days.[35] PCCW also notes that the *Enterprise Act* provides for the Secretary of State to, by order, shorten these statutory time periods set out for completion of investigations by OFT and the CC.[36]

- In Canada, parties must wait between 14 and 42 days after notification before completing a proposed transaction, which periods may be reduced by the Commissioner of Competition.[37] Parties are usually informed on the day that the relevant waiting period expires either that the transaction does not raise any concerns or that the assessment is not yet complete, at which point the Bureau endeavours to communicate its preliminary concerns.[38] The Canadian *Merger Enforcement Guidelines* provide that in most cases a determination can be made as to whether the merger prevents or lessens competition substantially within 8 weeks after the parties have provided all requested information, although noting that the "most complex" of cases can take up to six months to finalize.[39]

(ii) Procedure for merger review

PCCW notes that the minutes of the Bills committee meeting on 3 December 2002 state that the administration would consider setting out procedures for handling representations on M&A transactions (e.g. by way of written submissions, conducting public hearings, recording oral representations etc) in the draft merger guidelines. As it stands, neither the Bill nor the Explanatory Note provide any indication as to what procedures will be adopted in respect of investigations under section 7P(1) and decisions under section 7P(5).

This is unacceptable from accountability, transparency and business certainty perspectives. It is notable in this regard that in the UK, the Competition Commission ("**CC**") has recently recognised that it needs to improve its procedures connected with hearing parties and is consulting on this[40], and that the EU has also recently proposed modifying its procedures for hearings.[41]

In line with the above considerations, PCCW submits that LegCo should set out the basic procedural requirements to be followed by the reviewing body in the Bill, with further details (such as regarding informal clearances or letters of comfort) to be set out in the merger guidelines. The Bill also needs to include appropriate protection for ensuring that the confidentiality of information provided by the merging parties is maintained, as the current protection afforded by section 7I of the *Telecommunications Ordinance* is manifestly inadequate in this regard.

3. PCCW'S KEY COMMENTS ON THE EXPLANATORY NOTE

(a) There must be consultation on the proposed Merger Guidelines before the Bill is passed

Given the number of key matters that are currently left to be included in the merger guidelines at the completely unchecked discretion of the administration (e.g. practical definition of a "merger", details as to what constitutes a "substantial lessening of competition", timeframes

[35] OFT. *Mergers: A guide to procedures under the Fair Trading Act 1973*, pp. 16, 21.
[36] *Enterprise Act* 2002, s 40(8).
[37] *Competition Act*, s 123.
[38] Competition Bureau, *Merger Enforcement Guidelines* (March 1991), section 6.5.
[39] Ibid.
[40] See Competition Commission consultation pages: http://www.competition-commission.org.uk/inquiries/enterprisebill.htm and http://www.competition-commission.org.uk/inquiries/ebrules.pdf
[41] see: "Commission adopts comprehensive reform of EU merger control" European Commission Press Release IP/02/1856 of 11 December 2002

and procedures for the conduct of merger investigations), it is essential that LegCo and the public see the final form of the proposed merger guidelines, before it decides whether it is appropriate to pass the Bill in its current or a modified form. Without sight of the actual proposed merger guidelines (and not merely an "explanatory note" as to what they may or may not eventually contain), it remains fundamentally uncertain how the extensive powers of the TA (or preferably the Competition Board) in relation to M&A matters will be exercised.

PCCW notes that members of LegCo have already raised concerns along these lines, and that it was in light of such concerns that it was proposed at the Bills committee meeting on 3 December 2002 that the administration consider ensuring that the guidelines are finalized after the M&A bill is enacted and published in the Gazette, but before it actually commences.

Unfortunately, this proposed solution does not address the key issue that the Bill should not be passed until it is finally determined what should be contained in the Bill (or in subsidiary legislation) and what should be left to be included in the merger guidelines. In PCCW's view, LegCo cannot reasonably make an informed decision on this until it knows the precise details of what will be contained in the merger guidelines.

Accordingly, PCCW proposes that the Government should conduct another, full, public, round of consultation that allows reasonable time for the telecommunications operators and other members of the public (e.g. including that sector of the public who are regularly involved in merger and acquisition work in Hong Kong), to make further comments on the actual proposed merger guidelines. It is also critical that members of the Competition Board are given time to review and agree on the proposed contents of the merger guidelines.

Clearly, as was the case in respect of the consultation on the regulation of mergers and acquisitions issued by OFTA on 17 April 2002, OFTA does not require any additional powers in order to do this. Equally, it is not necessary for the proposed new section 6D(2A) of the *Telecommunications Ordinance* contained in the Bill to be enacted in order to ensure that the consultation is adequate. The terms of the consultation may either be informally agreed with LegCo, or else the Secretary may issue a written policy direction to OFTA to conduct an appropriate consultation under section 6A(2) of the *Telecommunications Ordinance*.

(b) Merger guidelines must not be "anti-merger"

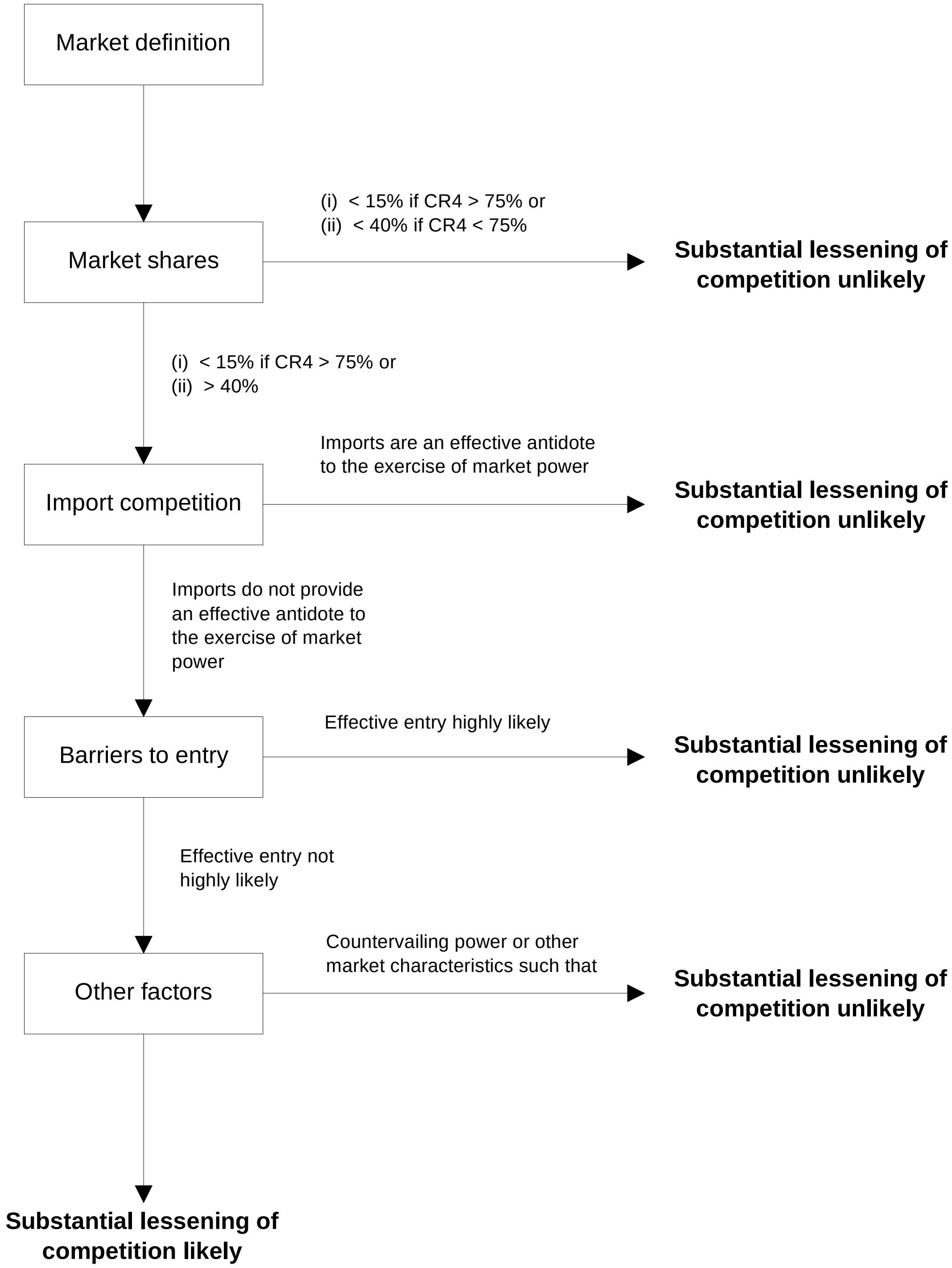
PCCW is concerned that the Explanatory Note is drafted on the basis of flawed reasoning and that this will flow through to poorly framed merger guidelines, which will prevent all but the smallest transactions.

In particular, the Explanatory Note's pre-occupation with opposing any merger which might potentially raise a competition concern appears to have led to draft merger guidelines which lack balance, which are inconsistent with global best practices, and would in practice ignore or pre-empt many of the factors that should be assessed as part of the investigation under the substantial lessening of competition test. Because of this, PCCW is concerned that merger guidelines based on the Explanatory Note would have the effect of substantially skewing the test towards prohibiting mergers that should not be opposed under the statutory substantial lessening of competition test.

Mergers can often be pro-competitive and produce substantial user and economic benefits, and it is not in the interests of promoting competition that merger prohibitions are interpreted so as to prevent those mergers. Accordingly, overseas merger guidelines (e.g. those in Australia, the US and Canada) recognise that if, following the merger, there is a factor or combinations of factors that will constrain the merged firm from acting anti-competitively. the merger will not substantially lessen competition merely because one or more other constraining factors ceases to apply. Thus, provided one or more sufficient constraints to anti-competitive conduct is identified, the merger investigation can cease without needing to assess other factors and/or the merger may be cleared in spite of unfavourable findings on those matters.

This approach is set out clearly in Figure 1 of the Australian Merger Guidelines, as duplicated below: It is this type of balance that is missing from the Explanatory Note.

Figure 1



Similarly (although unlike the Australian approach choosing to consider all relevant factors), the Canadian *Merger Enforcement Guidelines* provide that:

"*Although it is important in every case to address the relevance of each of the factors highlighted in section 93 in assessing the effects that a merger is likely to have on competition, some factors may have more importance than others. Indeed, the assessment of information relating to future entry [s 93(d)], business failure and exit [s 93(b)], or effective remaining competition [s 93(e)] may, in certain circumstances, provide a sufficient basis, in and of itself, for concluding that a merger is not likely to prevent or lessen competition substantially. That is to say, this conclusion may be arrived at notwithstanding the existence of information that is, on balance, unfavourable to the merger in terms of each of the other factors that may be relevant under section 93.*" (section 4.1)

It is not at all clear from the Explanatory Note that this will be the approach adopted by the TA. In fact, although the Explanatory Note does not contain similar comments, comments made by the TA in the Consultation Paper that

"*At each step, the presence or absence of a particular merger factor will indicate whether the merger is likely or unlikely to be anti-competitive in terms of the Telecommunications Ordinance. However, the presence or absence of a particular merger factor will not be conclusive in itself. The TA will consider the interaction of all relevant factors before coming to a conclusion.*"[42]

suggest that the TA proposes to adopt an inefficient merger review process involving detailed review of unnecessary issues, and, of even more concern, may not approve pro-competitive mergers because undue weight is given to less significant merger factors and/or insufficient weight is given to key factors.

Clear legislative provisions regarding safe harbours and minimum concentration levels will go some way towards alleviating these concerns. However, LegCo should also ensure that the proposed merger guidelines are suitably balanced, and do not convey the same "anti-merger" stance as is currently contained in the Explanatory Note.[43]

(c) Removal of a vigorous and effective competitor

PCCW is concerned that the Explanatory Note overstates the importance of whether or not a merger will result in the removal of a vigorous and effective competitor.

Any horizontal merger (unless it involves a failing firm) will necessarily result in the removal of a competitor who is to some extent vigorous and effective. It will not, however, necessarily result in a lessening of competition, and it is important not to confuse the goal of protecting competition with a goal of protecting individual competitors from stronger competitors or simply maximising the number of competitors.[44] Indeed, as noted in the Australian *Merger Guidelines*,

"*In some instances a merger which breaches the concentration thresholds may create a more vigorous competitor in the marketplace. For example,*

[42] Flow Chart: "Systematic Process for Assessing Prevention or Substantial Restriction of Competition" attached to draft guidelines annexed to the Consultation Paper.
[43] The failure to date of OFTA to articulate such detailed guidelines and road maps is likely to reflect a lack of expertise, highlighting both the preference to rely on the Competition Board and the need to perhaps re-think this entire exercise.
[44] See, for example, World Bank, *Telecommunications Regulation Handbook* (November 2000), para 5.1.2, which notes that "…*there is a tension between the objective of protecting competition and a more problematic practice of protecting individual competitors.*"

> *a merger between two smaller companies may create a more efficient combined form which is then able to compete more effectively with larger rivals*."[45]

Accordingly, PCCW recommends the inclusion in the merger guidelines of a statement to the effect of that contained in the Canadian *Merger Enforcement Guidelines*, which provide that:

> "*…the removal of a vigorous and effective competitor through a merger is generally not sufficient, in and of itself, to warrant enforcement action under the Act…there must also be findings unfavourable to the merger in terms of other factors, in particular, effective remaining competition and future entry*."[46]

(d) Barriers to entry

PCCW is concerned that the Explanatory Note appears to suggest that a merger investigation would need to assess barriers to entry (and thus that high barriers to entry may prove a substantial hurdle to merger approval) even if other competitive factors such as extensive and intense competition between existing market participants were present. This is particularly worrying, considering that the administration seems to have already pre-determined, in supporting M&A regulation which is limited to telecommunications carriers, that there are significant barriers to entry in the markets proposed to be regulated. The logic of this is that due to high barriers of entry in the telecom sectors covered by the Bill, OFTA would not likely approve any mergers.[47]

In other jurisdictions, low barriers to entry are generally considered in the context of being a factor which, even though concentration levels resulting from the merger may breach statutory thresholds or otherwise cause concern, will result in the merger not being likely to significantly reduce competition. For example, the Canadian *Merger Enforcement Guidelines* provide that:

> "*In general, the Director will conclude that a merger is not likely to prevent or lessen competition substantially where it can be established that, in response to the merger or to the exercise of increased market power resulting from the merger, sufficient entry into the market would occur to ensure that a material price increase would not likely be sustainable in a substantial part of the relevant market for more than two years. Conversely, information indicating that barriers to entry are high cannot provide a sufficient basis, in and of itself, for concluding that a merger is likely to prevent or lessen competition substantially."*[48]

In line with overseas practice, PCCW submits that more appropriate wording for paragraph 40 of the Explanatory Note might be:

> *"If other competitive constraints are insufficient, it is necessary to examine if the barriers to entry to the relevant market are low and whether they*

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[45] ACCC, *Merger Guidelines* (June 1999), para 5.140.

[46] Competition Bureau, *Merger Enforcement Guidelines* (March 1991), section 4.8.

[47] See for example, (LC Paper No. CB(1)187/02-03(01): Summary of Deputations' views and Administration's response, p 15, where the Administration states that "*The current proposal is to apply the M&A regulation to carrier licensees only because we are not aware of any current market factor such as high barrier to entry, high concentration level and scarcity of spectrum which may cause concern about possible over-concentration in the telecommunications market for non-carrier services*."

[48] Competition Bureau, *Merger Enforcement Guidelines* (March 1991), section 4.1. See also DoJ and FTC, *Horizontal Merger Guidelines* (2 April 1992, revised 8 April 1997), p. 25 and World Bank, *Telecommunications Regulation Handbook* (November 2000), para 5.4.2.

would be altered by the acquisition in assessing whether a merger or acquisition would substantially lessen competition in that market."

PCCW is also very concerned that paragraphs 41-50 appear to pre-empt key assessment issues as to whether the factors referred to do, in fact, constitute relevant barriers to entry. In particular, PCCW notes that:

Paragraph 42 seems to have pre-empted the key assessment issues with respect to sunk costs. Telecommunications can but does not necessarily involve large sunk costs. Even where there are sunk costs, new technologies have enabled entry without the duplication of such sunk costs such that those past investments are stranded and of no on-going competitive effect.

Paragraph 43 seems to have pre-empted the key assessment issues with respect to networks. Networks can but do not necessarily involve large sunk costs. Further, even when networks are used to provide a service it depends upon which telecommunications service/ market is relevant as to whether the sunk investments in networks are competitively significant or not.

Paragraphs 44-5: Economies of scale are present in almost all industries yet they have a significant competitive effect in only some industries. These paragraphs appear to miss the fundamental competition point about economies of scale in merger analysis. In Hong Kong, the density of telecom lines is uniquely high meaning that both incumbents and new entrants can capture the economies of density, the latter with relatively very low market capture shares. The key questions are:

(a) In respect of barriers to entry, how many businesses of minimum efficient scale can be accommodated on a sustainable basis given the quantity demanded within the market and is that sufficient to enable workable competition?

(b) In respect to pricing decisions, are economies of scale such that even a monopolist or oligopolist would chase volumes to the extent that pricing would nevertheless be undertaken on a competitive basis?

Paragraph 49 appears to have prejudged whether local loops constitute an essential facility (let alone a relevant barrier to entry, given the regulatory obligations that apply in respect of it). This is extremely troubling when OFTA will soon institute a broad consultation on this exact issue.[49]

The examples of potential strategic barriers to entry in paragraphs 53-57 are inappropriate in the context of the current telecommunications regulatory regime in Hong Kong. This regime provides a complex set of ex ante and ex post competitive controls which prevent operators from being able to engage in the kinds of anti-competitive conduct referred to (e.g. pushing prices down to levels that would not allow new entrants to recover their costs, or raising rivals costs).

(e) Vertical integration and vertical mergers

PCCW is concerned that paragraph 58 of the Explanatory Note appears to pre-empt any real investigation of whether a vertical merger would substantially lessen competition by stating that:

> "*Where there is market power at one functional level, there are obvious incentives where there is vertical integration (or a vertical merger) to*

[49] See for example World Bank, *Telecommunications Regulation Handbook* (November 2000), para 5.2.4, which notes that "*If alternative sources of fixed and wireless local loops become available, they may no longer be designated as essential facilities*.".

leverage that market power into the vertically-related market for anti-competitive purposes".

This is not the case. It is common for firms to maintain limited vertical integration as well as supplying competing firms, particularly in industries in which the upstream parts of the industry are highly capital intensive and there is excess capacity. In those circumstances the incentive upon a vertically integrated firm can be strongly to demonstrate to customers that there is no favouritism in order to retain or attract customer-competitors who can be suspicious of buying from a competitor. For example, where there are two mobile phone network owners the incentives can be very strong to attract and retain skilled re-sellers who can often grow customer bases in ways that a vertically integrated operator could not itself (e.g. Virgin Mobile in Australia).

Significant pro-competitive vertical mergers can also occur to underpin upstream investments (i.e. so that upstream investors can avoid, or at least accurately assess, the risks of infrastructure stranding). In other cases, upstream firms best understand the challenges and needs of their downstream customers and thus serve customers better if they have a direct understanding of those downstream businesses through vertical integration.

Where vertical integration of the merging parties or a vertical merger does in fact raise competition concerns, PCCW is also concerned that the Explanatory Note indicates that such concerns may be given undue weight.

In Australia, for example, any potential detrimental effects of vertical relationships and vertical mergers are only assessed <u>if</u> the merged firm breaches the concentration thresholds, <u>and</u> there is an absence of effective import competition <u>and</u> there are high barriers to entry.[50] Similarly, PCCW considers that the Explanatory Note should make it clear that vertical integration will not, on its own, be a factor that would result in a substantial lessening of competition.

In addition, further regard should be had to the impact of the many ex ante and ex post regulations that already govern the competitive conduct of telecommunications operators in Hong Kong, and thus significantly reduce the concern that might otherwise be caused by vertical integration – for example the concerns raised in paragraph 63 of the Explanatory Note.

<u>(f) Efficiencies and consumer benefits</u>

The "substantial lessening of competition" test proposed in the Bill is based on the Australian and Canadian competition law mergers test, which are in turn codifications of US case law on mergers. The Australian, Canadian and US regimes do not seek to promote competition as an end in itself. Rather they seek to foster competition as a <u>means</u> to the public policy end of promoting economic efficiency and thus total welfare.[51]

Similarly, it is generally the Hong Kong Government's policy to promote competition in the telecommunications market as a <u>means</u> of benefiting consumers, business and the Hong Kong economy.[52] PCCW is concerned that the administration has lost sight of this end goal, and that the Explanatory Note accordingly places insufficient weight on the benefits that mergers and acquisitions can bring in terms of efficiency gains and other public benefits.

For example, PCCW is concerned that the statement in paragraph 73 of the Explanatory Note that

[50] ACCC, *Merger Guidelines* (June 1999), para 5.151.
[51] See for example section 2 of the Australian *Trade Practices Act* 1974 (the act that regulates mergers in Australia), which provides that *"The object of the Act is to enhance the welfare of Australians through the promotion of competition and fair trading and provision of consumer protection."*
[52] See, for example, ITBB CR 7/13/14(02) Pt.3, paras 1, 20.

"…*efficiencies are only likely to make a difference in merger analysis when the likely adverse effects on competition, absent the translated efficiencies, are not great*"

lies in stark contrast to the LegCo Brief to the Bill, which claims that

"*Our proposal will…not only effectively deter anti-competitive behaviours but will also facilitate the making of informed commercial decisions on merger and acquisition activities that can achieve efficiencies such as economies of scale, synergies and risk spreading*."[53]

The Explanatory Note should instead reflect that a proper application of the "substantial lessening of competition" test involves the assessment of all the competitive factors and no other factors of "justification". A more balanced view on the pro-competitive effects of efficiencies might follow the Australian *Merger Guidelines*, which provide as follows:

"*Where a merger enhances the efficiency of the merged firm, for example by achieving economies of scale or effectively combining research and development facilities, it may have the effect of creating a new or enhanced competitive constraint on the unilateral conduct of other firms in the market, or it may undermine the conditions for coordinated conduct. Pecuniary benefits, such as lower input prices due to enhanced bargaining power, may also be relevant…If efficiencies are likely to result in lower (or not significantly higher) prices, increased output and/or higher quality goods or services, the merger may not substantially lessen competition.*"[54]

The US *Horizontal Merger Guidelines* may also be followed, which provide as follows :

"*Competition usually spurs firms to achieve efficiencies internally. Nevertheless, mergers have the potential to generate significant efficiencies by permitting a better utlization of existing assets, enabling the combined firm to achieve lower costs in producing a given quantity and quality than either firm could have achieved without the proposed transaction. Indeed, the primary benefit of mergers to the economy is their potential to general such efficiencies.*

Efficiencies generated through merger can enhance the merged firms' ability and incentive to compete, which may result in lower prices, improved quality, enhanced service, or new products. For example, merger-generated efficiencies may enhance competition by permitting two ineffective (e.g., high cost) competitors to become one effective (e.g., lower cost) competitor."[55]

PCCW is also concerned about comments by the administration that "*It would be in the interests of the consumers/public to promote effective competition…there is no need to add in a public interest consideration*".[56] In several other jurisdictions (such as Australia) it is recognised that, while the promotion of competition is usually in the best interests of the public, there may be circumstances where permitting a merger to go ahead is considered to be in the best interests of the public, even though it will or is likely to result in a lessening of competition. In Australia, for example, the *Trade Practices Act* and the *Merger Guidelines* set out as possible such circumstances including:

[53] ITBB CR 7/13/14(02) Pt.3, para 20.
[54] ACCC, *Merger Guidelines* (June 1999), paras 5.172-3.
[55] DoJ and FTC, *Horizontal Merger Guidelines* (2 April 1992, revised 8 April 1997), p. 30.
[56] (LC Paper No. CB(1)187/02-03(01): pp. 7-8.

- fostering business efficiency, especially where this results in international competitiveness;
- industrial rationalisation resulting in more efficient allocation of resources and in lower or contained unit production costs;
- expansion of employment or prevention of unemployment in efficient industries and employment growth in particular regions;
- improvement in the quality and safety of goods and services and expansion of consumer choice;
- supply of better information to consumers and businesses;
- promotion of industry cost savings resulting in contained or lower prices at all levels of the supply chain;
- development of import replacements; and
- growth in export markets.[57]

PCCW submits that public interest considerations other than simply whether or not competition has been substantially lessened should similarly be an aspect of merger review in Hong Kong. Given the important public policy implications, these factors should be set out in the Bill.

(g) Failing firms

In many overseas jurisdictions[58], mergers with or acquisitions of "failing firms" are acknowledged as involving special circumstances that are likely to reduce the anti-competitive effects that may otherwise be associated with the transaction. This is essentially for the reasons set out in the Canadian *Merger Enforcement Guidelines*, as follows:

> "*It is important to assess the financial health of the parties to a merger from a competition perspective, for three principal reasons. First, the loss of the actual or future competitive influence of a failing firm cannot be attributed to the acquisition of such a firm whether firm would have exited the relevant market in any event. Second, the extent to which the acquisition of a failing firm can increase the market power of the acquiror is often reduced as the failure of the former becomes increasingly likely, and as its relative market position weakens. Third, the likelihood that any market power effects that will materialize subsequent to the merger can be avoided through one of the alternative discussed below is typically reduced as the failure of the firm in question become increasingly likely*."[59]

As further noted in the Australian *Merger Guidelines*:

> "*It is part of the competitive process that firms will fail, either because of internal problems or due to external changes in market demand and resultant excess capacity. In such circumstances mergers can be an effective means of putting resources to alternative uses and/or improving efficiency through rationalisation*."[60]

In light of such comments and considerations, PCCW is concerned that paragraphs 74-78 of the Explanatory Note propose considerations in respect of failing firms that would appear to make it extremely difficult, if not impossible, to successfully raise a "failing firm" type justification in respect of a telecommunications merger or acquisition.

[57] See *Trade Practices Act* 1974, s 90(A) and ACCC, *Merger Guidelines* (June 1999), para 6.38.
[58] For example the US – where there is a "failing firm defense", Canada and Australia.
[59] See Competition Bureau, *Merger Enforcement Guidelines* (March 1991), section 4.4.1.
[60] ACCC, *Merger Guidelines* (June 1999), para 5.143

In particular, PCCW notes that given the relatively high sunk costs involved in the telecommunications industry, it would be very rare to expect that a failed firm's assets would exit the market. In fact, the continued availability of such assets makes market entry easier and itself acts as a constraint on anti-competitive conduct.

CONCULSION

In summary, PCCW believes that the Bill should be rejected because (1) the administration has not demonstrated any need for the Bill; (2) M&A regulation applying purely to the telecommunications sector is fundamentally out of line with global best practice, good public policy, economics and law and; (3) the Bill will be counter-productive, in terms of increasing uncertainty in the market, discouraging investment and ultimately harming the industry and end-users.

If LegCo nevertheless pushes ahead with the Bill, some fundamental changes need to be made to the Bill to prevent it from being manifestly defective and unduly intrusive. Critically, (1) the current double merits review process should be replaced with primary M&A review by the Competition Board; (2) the Bill must clearly define an M&A transaction as something that results in a change in control; (3) the Bill must clearly establish that only M&A transactions of true competitive concern will be reviewed and give clear guidance as to factors to be considered and transactions that are not regulated; (4) the Bill must contain binding statutory timeframes for M&A reviews and (5) the Bill must set out the procedure for M&A reviews, including appropriate confidentiality protection.

In terms of merger guidelines, the key issues in respect of which LegCo must satisfy itself are (1) that they do not inappropriately prevent beneficial and pro-competitive M&A transactions and (2) that all relevant issues have been adequately addressed in the proposed guidelines <u>before</u> any M&A Bill is passed.

PCCW 27 February 2003