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The Hon Sin Chung-kai
Bills Committee Chairman
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Dear Sir

Telecommunications (Amendment) Bill 2001 – Submission in response to the Explanatory Note on the M&A Guidelines

This submission is made by Telstra Corporation Limited which owns Hong Kong CSL Limited.

We welcome the opportunity provided by the Legislative Council Bills Committee to comment on the *Explanatory Note on the Guidelines on the Competition Analysis of Mergers and Acquisitions in Telecommunications Markets* ("**M&A Guidelines**") as set out in LC Paper No. CB(1) 597/02-03(1) ("**Explanatory Note**").

A. Introduction

Before commenting on the Explanatory Note, we respectfully reiterate that we have serious concerns with regard to the **Telecommunications (Amendment) Bill 2001.** In section B below, we have set out a summary of the concerns we have previously outlined in respect of the proposed Bill. The summary also contains some further information on recent developments.

We have also taken this opportunity to expand on some aspects of our earlier submissions. In particular, we have commissioned an opinion from a renowned economist (Professor Henry Ergas B.A. (Econ.) (Hons) M.Ec.Stud) in relation to the threshold issue of whether it is appropriate to have industry specific competition laws. Section C contains our further comments on this issue and the opinion from Mr Ergas is set out in the appendix to this letter. The appendix also contains Professor Ergas' CV.

B. Summary of our Earlier Submissions

Our concerns have been previously expressed and can be summarised as follows:

1. Minimal Regulatory Intervention

We consider that the Legislative Council should support a presumption of minimal regulatory intervention. Accordingly, before an industry is subject to any additional regulation, the Legislative Council should insist that there is clear justification for the additional regulation.

The Hong Kong telecommunications industry is very competitive by world standards. In fact, Hong Kong has one of the highest mobile penetration rates in the world. We therefore fail to see the need to introduce stringent mergers and acquisitions legislation in such a competitive market. Moreover, we have not seen any material demonstrating that there have been any mergers or acquisitions in Hong Kong which the existing regulatory regime has not been able to deal with in a manner that is entirely adequate.

It says a great deal that there are very few developed countries that have industry specific merger control but many have general competition laws. For example, 5 of the 6 jurisdictions listed in the presentation made to the Bills Committee on 25 July 2002, ignoring Hong Kong, have general (rather than industry specific) competition law. This indeed is the broader issue that the Legislative Council needs to consider. The OECD and the World Bank in "A Framework for the Design and Implementation of Competition Policy" (1999, World Bank, Washington DC) tend to prefer broader competition laws than sector specific laws. Moreover, Australia's Hilmer Report concluded (at page 85) that there are "compelling efficiency and equity arguments for ensuring that competitive conduct rules ... are applied uniformly and universally throughout the economy".

More recently, in its publication "*Trade Policy Review, Hong Kong China*" (World Trade Organisation, 18 November 2002), the World Trade Organisation commented (at page 38) that:

> *"The existence of different rules for different sectors could lead to a distortion of resource allocation because firms would choose to enter sectors with clear competition rules, so that they could not be coerced by incumbents. Moreover, regulators (for instance in telecommunications) have to perform a dual role of traditional regulator and of enforcer of competition policy, which could compromise their impartiality. Different regulators may also interpret competition provisions differently and possibly inconsistently. An independent competition body/agency/authority might well better promote and enforce competition."*

This issue is set out in further detail in section C below.

Moreover, consistent with the approach of the World Trade Organisation, Singapore has announced that it will pass generally applicable unfair competition laws (see speech by Deputy Prime Minister, Lee Hsien Loong, at the Institute for International Economics, 13 November 2002).

In any event, the existing approach of the TA of including in licences issued under the Telecommunications Ordinance a condition which prohibits a licensee registering a transfer of shares in itself without the prior written consent of the TA should adequately address the TA's concerns. Although this framework does not catch upstream transfers, the regime is sufficiently flexible to enable the TA to address such transfers in a similar way.

Accordingly and in the absence of any compelling reason for the introduction of industry specific mergers and acquisition regulation, CSL submits that Legislative Council should not impose such legislation on the telecommunications industry.

2. **Need for transparency and consistency**

Our fundamental proposition is that the tests to be applied and the procedures to be adopted (including decision making timeframes) must be transparent and consistent and ensure that the TA is fully accountable. A significant and valid criticism in other jurisdictions is the lack of transparency, consistency and regulatory accountability. Consistent with this, most of the amendments we have previously suggested are aimed at ensuring that the Telecommunications Ordinance provides a framework in which the TA is accountable and that the TA exercises its powers in a transparent and consistent manner. For example, we have submitted that:

the change of control threshold is too low;

the guidelines issued by the TA under section 6D should be subject to review by the Legislative Council;

the scope of directions issued by the TA under section 7P(should be determined on an objective basis and be confined to Hong Kong;

- the TA should only be permitted to issue a direction under section 7P(1) if it is in the public benefit to do so;
- there should be a time limit specified in clause 7P(1) during which the TA may exercise his power to issue directions after a change of control;
- the TA should also be permitted under section 7P(6) to consent to changes in control which are in the public benefit;
- the proposed statutory basis for voluntary pre-approval in section 7P(5) and consent given by the TA in section 7P(6) should incorporate clear statutory procedures;
- there should be a limit on the costs which may be recovered by the TA under section 7P(11) for considering an application under subsection 7P(5); and

appeals under section 32L to the Appeal Board should be on their merits and the timeframes for appeal increased.

C. Industry Specific Competition Laws

As a general economic principle, the introduction of separate laws and bodies regulating mergers and acquisitions in telecommunications is undesirable[1] If a mergers and acquisitions law is regarded as desirable, then it should apply to *all* firms and industrial and economic sectors in a country, not just some of them.

This is a lesson that can be drawn from various studies of the differences between sector-specific and generic regulation. See Organisation for Economic Cooperation and Development. (1999). Relationship between Regulators and Competition Authorities and Organisation for Economic Cooperation and Development and World Bank. (1999). A Framework for the Design and Implementation of Competition Policy.

Furthermore, the introduction of a mergers and acquisitions law applying to telecommunications to the exclusion of all other industries in Hong Kong is undesirable for the following reasons:

- The potential for grave mistakes to be made under sector-specific regulation is greater than under generic competition laws. The reasons for this are discussed in greater detail in the Appendix below. As a result, extending regulation of telecommunications to regulation of its structure (by regulation of mergers and regulations) will further increase the opportunities for regulatory errors to be made. As long as Hong Kong persists in sector-specific regulation, the goal of quarantining as much as possible the scope for regulatory error should remain an important one.

- Adding to this concern is the fact that the magnitude of harm under erroneous regulation of structure is greater than the magnitude of harm under erroneous regulation of conduct. Whereas the latter provides some options for the regulated party to take mitigating steps (by choosing other, albeit less efficient means of achieving its objectives), the former involves a regulator in making decisions (primarily about what the 'desirable' industry structure should be) that are more difficult or impossible to unravel.

- It could be argued that adoption of such structural regulation complements existing conduct regulation because it proactively thwarts the development of dominance that would otherwise later be abused. However, this must be balanced against the greater propensity for regulatory error and higher costs of such error associated with structural regulations. The question that needs to be asked is whether the benefits of such proactivity are worth these costs given that: i) conduct regulation can still keep any abuse of dominance in check even though it 'lets through' relatively more conduct that may lead to opportunities for abuse of dominance in the future[2]; ii) the need for Hong Kong as a small, open economy to have a pre-emptive structural intervention policy in addition to conduct regulations is not as compelling. On balance the tradeoffs favour a 'less is more' approach – that is, in the absence of generic competition regulation Hong Kong should not add to the toolset available to the sectoral regulator but focus on making full and effective use of what is currently available.

- The higher risk premium that will be demanded for investment in the telecommunications industry because of the effects of increased and more costly regulatory errors may endanger the competitiveness of the industry (for more details see the arguments in the Appendix on why general competition regulation should be preferred to sector-specific regulation for these same reasons).

- The proposed regulations will further increase the compliance costs on the telecommunications industry by adding to the layer of conduct-based regulation that already exists. Such compliance costs will have the greatest repercussions for providers of 'convergence' technology services. This is discussed in greater detail in the Appendix which argues that general competition regulation should be preferred to sector-specific regulation for these same reasons.

- The proposed regulations establish an undesirable precedent for the development of a more general mergers and acquisition law in Hong Kong, setting the stage for further, inefficient,

[2] Note that this does not mean that conduct regulation cannot also perform a proactive role. Conduct regulation can, for instance, outlaw foreclosure arrangements that enhance dominance. Thus it is not so much that structural regulation is pro-active whereas conduct regulation is not. Rather it is that structural regulation can potentially prevent more cases of emerging dominance than conduct regulation can.

'piecemeal' extensions of laws to other sectors and diverting attention from the need to develop an economy-wide mergers and acquisitions law for Hong Kong (the reasons why multi-sector competition law is preferable are discussed in the Appendix); and

Overall, the regulation is an unnecessary step, given that anti-competitive conduct in telecommunications is already regulated under the Telecommunications Act. The prevailing conduct-based regulation of the telecommunications industry has, as noted in the submission, already facilitated the development of a highly competitive telecommunications market in Hong Kong. To introduce merger regulation on top of that would mean spending administrative resources on extending regulation of the telecommunications industry to include what are in effect 'structural' regulations. Those resources could have been better spent on improving current regulation of conduct or in other areas (including the development of more generic competition laws). Thus, in addition to being a waste of resources, the only consequence of the proposal would be to introduce economic distortions into the Hong Kong economy as one industry would be unnecessarily singled out for regulation of its structure as well as of its conduct.

- Finally, it is worth noting that the ability given to the regulator to micromanage a whole industry's structure conferred by the proposed laws is directly inimical to Hong Kong's long tradition of market-based policies supplemented by cautious interventionism – a tradition that has proven to be successful thus far. Conduct-based regulations fall into a different category altogether from the proposed merger laws and are more consistent with this tradition of cautious interventionism. Experience should be a guide, if not the only guide, to policy.

Given these considerations, regulation of industry structure ought not to be added to the set of instruments available to the industry-specific regulator unless it can be shown first, that the current conduct regime is insufficient to ensure appropriate regulation, and second, that adding to that regime controls over industry structure would yield benefits greater than its costs.

Seen in the light of this test, it seems to be the case that the current arrangements are not inadequate; that adding industry structure to the range of regulatory controls would increase the risk of regulatory error, and hence increase the costs of providing telecommunications services in Hong Kong; and lastly, would involve deferring an opportunity to press for a non-industry specific approach to competition policy.

D. Structure of the Telecommunications Authority

The trend in international best practice for the structure of authorities which have powers in the nature of the power in the proposed section 7P is for the statutory power to vest in a board or commission rather than an individual. Given the significant consequences of decisions regarding industry structural issues, it is preferable that such powers are vested in a board or commission so as to:

increase the independence of the decision making body (that is, the actual enforcement decision is taken by a board or commission rather than the public servants responsible for the initial investigation and analysis); and

improve transparency and accountability.

In the case of the Telecommunications (Amendment) Bill, the power granted by the proposed section 7P will vest in an individual, namely, the person who is the Telecommunications

Authority. This approach is inconsistent with approaches taken, or about to be taken, in other jurisdictions. For example:

(a) in Australia, the power in the nature contemplated by section 7P is vested in a commission;

(b) in the United Kingdom, the merger control decisions are made by the Secretary of State on advice of the Director General of Fair Trading. The Enterprise Act 2002 will replaced this structure with a new body, the "Office of Fair Trading", which will be headed by a board rather than by one person;

(c) Europe's Competition Commissioner announced on 11 December 2002 her decision to establish new internal procedures by the creation of "peer review panels" to cast a fresh pair of eyes over every merger inquiry.

We note that the recent reforms in Europe are the result of claims that there is a lack of internal checks and balances[3].

Accordingly, we submit that if the Legislative Council does enact legislation granting powers in the nature of those set out in the proposed section 7P, those powers should be vested in a board or commission rather than in the Telecommunications Authority.

E. Comments on Explanatory Note

As a general comment, we note that the Explanatory Note only sets out the TA's preliminary views on key matters. It is therefore unclear as to how comprehensive and definitive it is as compared to the proposed Guidelines. The Explanatory Note is merely a bare framework at most and is insufficient to form a basis for public consultation and review.

We therefore reserve most of our comments until a complete draft of detailed M&A Guidelines has been made available by the TA.

However, we have identified in this submission two issues which are critical and thus <u>must</u> be addressed by the M&A Guidelines to ensure the effective operation of the Hong Kong regime.

First, the M&A Guidelines must contain robust and appropriate safe harbour provisions directed at both the change in control threshold and the level of permitted market concentration.

- Second, the M&A Guidelines must clearly define a procedure for industry participants to approach the TA to obtain *ex ante* clearance for their proposed transactions.

Both matters will greatly assist in providing greater *ex ante* certainty to industry participants regarding the legality of proposed transactions thereby improving compliance, increasing transparency, reducing administrative cost, and reducing regulatory risk.

1. Safe harbour provisions

We submit that industry requires greater *ex ante* certainty regarding the circumstances in which the TA will consider that a substantial lessening of competition is <u>not</u> likely to arise. This can be achieved if the M&A Guidelines were to more precisely demarcate the set of

[3] See for example, the Financial Times, 23 October 2002 "Brussels wrong to block French merger court ruling: Pressure rises on European Union competition Commissioner to make radical changes to M&A rules."

transactions in which the TA is unlikely to have any interest, namely via the use of robust and appropriate safe harbour provisions. Such an approach is consistent with the approach of other jurisdictions that do not require mandatory notification such as Australia and New Zealand.

(a) Change in control thresholds:

The M&A Guidelines should identify that the TA will be principally concerned only with changes in control that confer *effective control.* This concept of effective control is used in most jurisdictions to screen out those transactions that are unlikely to raise competition issues. Various factors for assessing effective control, for example, are set out in paragraph 3.27 of the Australian Merger Guidelines as a useful precedent (e.g., >50% voting control).

The TA should then clearly identify the additional circumstances in which changes in control less than those conferring effective control may still raise competition concerns. Again, such additional circumstances are usefully identified in paragraphs 3.19 to 3.24 of the Australian Merger Guidelines as a useful precedent (e.g., shareholder agreements, asymmetrical voting rights).

Importantly the M&A Guidelines should contain a presumption that if a change in control does not confer effective control, and does not involve these additional circumstances, the change in control will not raise competition concerns for the TA.

(b) Concentration ratio thresholds:

In paragraph 3.13 of the initial consultation paper issued by the TA on 17 April 2001, the TA adopted the Australian "CR4" concentration ratio. Under the Australian CR4 ratio, a merged entity with a market share of less than 40% is only considered relevant if the *top four firms* in the relevant market have a market share greater than 75% (ie post consolidation).

However, in paragraph 31 of Annex A of the Explanatory Memorandum the TA now appears to have moved away from the Australian ratio and has adopted a lower threshold based on the market share of the *merged entity alone.* We submit that the lowering of the concentration threshold in this manner is inappropriate and provides little, if any, guidance in demarcating the set of transactions in which the TA is unlikely to have any interest.

In particular, Australia, for example, adopts the "CR4" concentration ratio to reflect the smaller size of its economy and generally more concentrated markets relative to other jurisdictions such as the US, EU and UK. The Australian Competition and Consumer Commission states in the Australian Merger Guidelines that it is unlikely to take an interest in a merger if:

- the combined market share of the largest **four** market participants is less than 75% and the proposed merged entity would have a market share of less than 40%; or
- the combined market share of the largest **four** market participants is greater than 75% and the proposed merged entity would have a market share of less than 15%.

New Zealand, for example, adopts a more liberal "CR3" concentration ratio recognising that its economy is even smaller and its markets even more concentrated than those in Australia. The New Zealand Commerce Commission is unlikely to take an interest in a merger if:

- the combined market share of the largest **three** market participants is less than 70% and the proposed merged entity would have a market share of less than 40%; or
- the combined market share of the largest **three** market participants is greater than 70% and the proposed merged entity would have a market share of less than 20%.

We submit that this is a fundamental issue in relation to which consultation and review occur.

2. Clearance procedure

The M&A Guidelines should set out a procedure for parties to voluntarily approach the TA to receive *ex ante* clearance that the proposed transaction does not raise competition concerns. Such an approach is used in most other jurisdictions that do not have a mandatory pre-notification procedure, including Australia and New Zealand.

A clearance procedure is critical in ensuring firms have sufficient *ex ante* certainty regarding the legality of their proposed transactions. In the absence of a clearance procedure, the level of regulatory risk for many transactions may be intolerably high therefore imposing a high cost to the Hong Kong economy by preventing beneficial transactions that may otherwise occur, potentially diverting investment into markets outside Hong Kong.

A clearance procedure should address at least the following issues. Each of these issues should be clearly set out in the M&A Guidelines:

- a basis for confidential approaches to the TA regarding a proposed transaction (in which case the parties to the merger recognise the risk associated with the fact that the TA will be unlikely to be in a position to provide a final view on the transaction given the absence of market enquiries);
- a basis for non-confidential approaches to the TA regarding a proposed transaction (in which case the TA would seek submissions from the industry and could provide a final response on the legality of the proposed transaction based on market enquires);
- the importance of permitting all existing and potential market participants to make submissions to the TA on proposed transactions before the TA can provide a final view on the legality of a transaction;
- the need for the TA to preserve the confidentiality of commercially sensitive information provided to the TA within the context of a clearance application;
- indicative time frames for clearance decisions. A clearance process should take around 30 days with the potential for extension in complex transactions or where market enquires are required. Such timing is consistent with that set out in the Australian Merger Guidelines, the Singapore Guidelines, and the New Zealand Merger Guidelines.

- indicative conditions that the TA may seek to impose as a basis for providing clearance, most likely subject to negotiation with the parties to the transaction during the clearance procedure; and

  identification of priority markets for the TA, constituting those markets in which the TA is most likely to take interest when considering enforcement action.

F. Conclusion

We urge the Legislative Council to take time and care to consider the inappropriateness of sector specific competition regulation and the fact that such regulation would put the Hong Kong SAR at odds with modern international competition regulation. In particular, the Legislative Council should note the potential harm that may be caused by inappropriate structural regulation and should ensure that the focus of the TA remains on the regulation of conduct.

We also urge the Legislative Council to comprehensively review the guidelines proposed and require that they be rejected in their current form and sent back to the TA for substantial review.

Please let us know if you require any further information relating to the above. We would welcome the opportunity to make further submissions and representations on this matter.

Yours sincerely

Simon Brookes
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Telstra International

Appendix

The importance of economy-wide competition law for Hong Kong

It is submitted that the development of a telecommunications-specific mergers and acquisitions law through passage of the *Telecommunications (Amendment) Bill 2001* deflects attention from the more pressing need to introduce a general competition law in Hong Kong.

Furthermore, it is my belief that incremental, sector-specific development of mergers and acquisitions laws in Hong Kong of the type that this Bill heralds will have negative consequences for the economy in the form of higher-than-necessary costs of regulation. Hong Kong will be pursing a pattern of regulation that is much less economically efficient than a general (multi-industry) mergers and acquisitions law. It is submitted that general competition law is to be preferred to sector-specific regulation for five main reasons:

- It is a waste of money to have more than one regulator doing the same thing;
- Under sector-specific regulation, there is a greater tendency for regulation of any particular activity to persist even when it is no longer needed, which means the incurring of unnecessary administrative and compliance costs. This is because a sector-specific regulator which voluntarily relinquishes its role in any particular area loses a proportionately larger part of its funding and status than a multi-sector regulator that does the same;
- A single regulator with responsibility for all mergers and acquisitions in a country is much more likely have the requisite experience and less likely to be disproportionately influenced by firms who are unhappy with the law or its application because all the firms in the economy have an interest in how the regulator behaves. Thus, a sector-specific regulator is less likely to make good decisions and to improve its performance over time than a general regulator (also see further reasons for this below)';

- A regulator that makes several decisions a year in a wide range of industries is more likely to make decisions that are correct than a regulator that makes a few decisions about only one industry. Regulatory decisions about the same issues should also be consistent – this is not assured when there is more than one regulator dealing with the same issue. Such inconsistency is undesirable because it leads to increased uncertainty for the firm, which in turn means that investors in the firm will demand a higher risk premium for their capital. Thus, industry-specific regulation could endanger Hong Kong's competitiveness in telecommunications; and

- Some firms (for example firms that provide both telecommunications and broadcasting services) will find that they are subject to more than one regulator and more than one law. They may decide not to invest in services that are regulated by a 'stricter' regulator, even though it would be better for consumers if they did. Furthermore, situations can arise (and are indeed increasingly likely to do so as convergence proceeds) in which firms need to seek permission for mergers or acquisitions from two regulators. This is not only a waste of money, but could lead to problems if the regulators disagree about what should be done.

These arguments are explained in more detail in the following sections.[1] It will also be explained that costs of the type outlined are more harmful in small economies than in large ones. In particular, the foregoing of administrative efficiencies through fragmentation of regulatory responsibilities constitutes a greater burden on a small economy, as does the imposition of higher risk premiums on investment in the regulated industry.

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1 For further discussion of the differences between sector-specific and generic regulation, including a discussion of the risks of capture, see Organisation for Economic Cooperation and Development. (1999). Relationship between Regulators and Competition Authorities and Organisation for Economic Cooperation and Development and World Bank. (1999). A Framework for the Design and Implementation of Competition Policy.

1. *Loss of regulatory economies of scale and scope.*

Sector-specific regulation means that scale and scope economies associated with generic regulation may be lost. At the simplest level, there are lost economies because certain fixed administrative costs cannot be shared between regulators (for example, the costs of administrative and other support staff as well as facilities costs). Furthermore, regulators with responsibility for determining questions of competition law and policy across several sectors are able to draw upon a common pool of experts (legal, economic, accounting, etc). Securing these economies of scope is obviously especially important in relatively small economies.

2. *Increased tendency for regulation to persist when it is no longer warranted.*

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 factors being the same. This is because the consequences for a sector-specific regulator of losing its functions are self-evidently more serious for that regulator than for a generic (multiple industry) regulator. The winding back or complete elimination of regulation pertaining to one sector necessarily involves a complete loss of responsibility (and funding) for a sector-specific regulator. By contrast, it represents only a proportionate loss of responsibility (and probably no loss of funding) for a generic regulator.

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. Generic regulators will still have a role to play even when there is no justification for regulating one of many sectors. 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.

3. Regulatory capture

'Regulatory capture' refers to the exercise of undue influence by a regulated entity or entities over the agency responsible for their regulation. At the extreme, a 'captured' competition agency acts not in the best interests of competition or economic efficiency, though it may be in the interests of regulated firms. Capture can occur in a number of ways including , because the regulator is persistently and successfully lobbied into adopting an unreasonably sympathetic attitude towards firms in the regulated industry.

Regulatory capture is a far more likely scenario in the case of sector-specific regulators than it is for generic or multiple-industry regulators. It is more cost-effective for an industry as a whole, or for a dominant firm within that industry, to expend effort upon influencing a regulator that deals only with them, as they would gain the full benefit from the effort thus expended. By contrast, a sector wishing to exert significant influence upon a generic regulator would find that part of any gain would flow to other sectors. Additionally, a sector-specific regulator is more susceptible to adopting the sector's perspective than a generic regulator, because constant contact with the sector's representatives to the exclusion of other industry representatives means it is not sufficiently exposed to alternate arguments and a 'global' perspective that enable it to develop a genuinely unbiased position.

4. Regulatory asymmetry and associated costs.

Even when regulation applying to a specific sector is first designed in a way that is extremely closely aligned with models of regulation in other sectors, disparities will emerge and worsen over time. Legislators tend to lose sight of the initial purpose of the regulation, appending new and inconsistent provisions with successive legislative amendments. More importantly, regulators give substance to and shape the direction of bare statutory provisions through decisions on individual cases. Two regulators can work within exactly the same statutory framework and yet develop over time bodies of precedent that operate in completely different ways. This is especially likely in the area of competition regulation, in which considerable latitude is left to regulators in the interpretation of concepts such as 'a substantial lessening of competition' or 'market power'.

This phenomenon is undesirable for three inter-related reasons. First, the opportunity to evolve a potentially strong, consistent and educative body of precedent is foregone, which makes regulatory precedent less valuable for investors in regulated industries, and for consumers and regulators too. In other words, firms in each of the regulated sectors can draw on only their own part of the body of precedent in seeking to predict regulatory behaviour in the future. There is a consequent reduction of certainty about future regulatory behaviour. This reduction of certainty increases the regulatory risk premium – and with it, the cost of capital to the regulated firm.[2] This results in losses in economic efficiency, as investment that should proceed does not.

Second, fragmenting the regulatory process reduces the likelihood that regulatory decisions will be objectively 'correct'. Regulators not bound (either in law or because of a self-imposed desire to act in conformity with previous decisions) by the decisions of regulators of other industries are not subjected to the discipline that arises from a need to seek consistency of reasoning or outcome, even when the issues for determination are identical. There is consequently a much greater risk that a regulator of only one sector may be swayed by extraneous or erroneous arguments in a case, causing it to arrive at a decision that is economically 'wrong'.

Lastly but importantly, a sector-specific regulator is not monitored by the firms it does not regulate – so it is exposed to less scrutiny and to narrower scrutiny. The pressures that otherwise force regulators towards economically efficient approaches to regulation are thereby blunted, all the more so as sector-specific regimes tend to diverge ever further over time.

5. *The effect of convergence*

It is conceivable that one firm may be technically subject to the jurisdiction of two regulators with different expectations and requirements. Regulation that is expressed to apply to a specific technology or activity is notoriously prone to this problem. A classic example is 'telecommunications-specific' regulation. In today's economy, firms supplying traditional 'telecommunications' services are also likely to supply other services, including broadcasting

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2 For more details on the argument that regulatory uncertainty increases a firm's risk premium see Ergas, H., J. Hornby, I. Little and J. Small 2001, Regulatory Risk. Available at http://www.necg.com.au/pappub/papers-ergas-regrisk-mar01.pdf

and content. There are situations in which, on the application of economic tests such as the SSNIP, the firms' services are true 'substitutes' for one another. Yet they may be subjected to the decisions of two different regulators (for example, a telecommunications regulator and a broadcasting regulator, or a telecommunications regulator and a general competition regulator). This can have adverse effects for economic efficiency. For example, there may be resource misallocation within the firm and within the economy as a whole, with investments tending to be made in those services subject to regulation that is perceived to be less stringent (without regard to consumer demand or least-cost service provision), in a desire to avoid the costs associated with fighting for regulatory approval.

There may also be duplication of compliance efforts and disagreements between regulators. For example, two firms that both provide telecommunications and broadcasting services that wish to merge or acquire significant interests in each other may have to seek the approval of two regulators. In the event of disagreement between regulators, it is not always clear how the question of jurisdiction would be resolved. In any event, it involves an unnecessary duplication of costs associated with seeking regulatory approval (preparation of experts' reports, hearings, etc).

6. *Consequences for small economies*

In very large economies, such as the US or the UK, costs of the type identified in the previous five sections may be less significant. This is because the sheer size of the economy means that the loss of economies of scope is more readily absorbed. At the same time, the sector being regulated may be sufficiently large that many of the economies of scale are achieved in any event.

However, in smaller economies such as Hong Kong, high costs are likely to arise from fragmenting regulatory responsibility. To begin with, smaller economies are less well placed to bear the duplication of fixed costs. Often, fragmented responsibility will mean that decisions in some areas simply cannot draw on the necessary pool of expertise.

Additionally, in a smaller economy, the impact of distorting investment decisions is likely to be especially great. The higher regulatory risk premium caused by fragmented regulation can weigh heavily on consumers, while any one firm's decision to defer investment because of regulatory risk is less likely to be offset by investment from competitors.

These consequences are especially adverse for economies that need to establish and maintain their credibility with foreign investors. Here ensuring an institutional framework that makes for the greatest consistency and predictability of policy should be an over-riding concern[3].

The Telecommunications (Amendment) Bill 2001 will distort the Hong Kong economy

Given that sector specific regulation is generally inferior to regulation that is applied on a competitively neutral basis economy-wide, the issue must nonetheless be addressed of how the proposed Bill would affect Hong Kong's efficiency and competitiveness, given that Hong Kong does not have generic competition legislation.

Hong Kong's telecommunications industry is very competitive by world standards. Furthermore, under the Telecommunications Act, anti-competitive **conduct** is already prohibited, and a range of instruments are in place for preventing and correcting any such conduct. Passage of the Bill would merely introduce the potential for the regulator to distort the **structure** of what is (i) already a competitive sector and (ii) a sector that is already safeguarded from anti-competitive consequences through existing law.

It would also introduce other distortions, including the distortions arising from the fact that telecommunications firms would need to comply with the law (which involves considerable expense, time and risk of failure) relating to mergers and acquisitions, whereas firms in other sectors of the economy would not. This could lead to the result that socially beneficial

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3 For studies that have found strong positive correlations between the consistency and predictability of the regulatory framework and economic growth see Barro, R. 1997, Determinants of Economic Growth: A Cross- Country Empirical Study (MIT Press); Hall, R. and C. Jones 1998, 'Why Do Some Countries Produce So Much More Output per Worker than Others?' Stanford University Working Paper No. 98-007; Rodrik, D., A. Subramanian and F. Trebbi 2002, 'Institutions rule: The primacy of institutions over integration and geography in economic development', IMF Working Paper and Scully, G. 1988, 'The institutional framework and economic development', Journal of Political Economy 96(3) among many others.

investment in telecommunications was reduced and funds diverted to other, possibly less-deserving, sectors of the Hong Kong economy.

Even more importantly, the magnitude of harm under erroneous regulation of structure is greater than the magnitude of harm under erroneous regulation of conduct. Whereas the latter provides some options for the regulated party to take mitigating steps (by choosing other, albeit less efficient means of achieving its objectives) the former involves a regulator in making decisions (primarily about what the 'desirable' industry structure is) that are generally more difficult to unravel. Additionally, while economics can give substantial guidance about whether many types of conduct are or are not desirable, judgments about the desirability or otherwise of particular industry structures are inherently uncertain. As a result, there is inevitably a great degree of discretion involved in determining whether particular mergers or acquisitions ought to proceed. It is therefore dangerous to vest this discretion in a regulatory structure that will be poorly placed to deal with it.

Given these considerations, it would only be desirable, from an efficiency perspective, to proceed with the Bill if it could be shown that:

(1) The current conduct controls are inadequate; and

(2) Expanding the range of regulatory controls to controls over structure would create benefits that exceeded its costs, including here the costs of incorrect decisions.

As Hong Kong's telecommunications sector is relatively competitive, and generally performing well, these tests do not appear to be met. It is therefore preferable to continue to rely on sectoral conduct regulation until a generic competition law regime can be developed and implemented. To do otherwise would merely harm Hong Kong's long term competitiveness.

HENRY ERGAS is the Managing Director of the Network Economics Consulting Group (NECG), a firm that provides economic advice on regulation, competition, trade practices and intellectual property across a wide range of industries. Henry has extensive international experience advising government bodies and major corporations in Australia, New Zealand and the European Union. Known especially for his work in telecommunications, he has also had substantial involvement in other network industries including electricity, natural gas, aviation, surface transport and financial services. He has carried out work on market power and conduct issues in telecommunications, airports, energy and railways, and provided statements and appeared as a witness in major competition law cases and access arbitrations. Henry recently chaired the Intellectual Property and Competition Review Committee set up by the Federal Government in 1999 to review, under the terms of the Competition Principles Agreement, intellectual property laws as they relate to competition policy. The committee presented its final report to the Commonwealth Attorney General and to the Minister for Industry, Science and Resources in September 2000. He advised the ACCC on its successful intervention in the Melway case in the High Court, which was determined in March 2001. He was appointed by the Solicitor General of New Zealand to be a Lay Member of the New Zealand High Court, assisting it in matters relating to competition, law in 2002.

ATTACHMENT 1 - CV OF HENRY ERGAS

NAME:	HENRY ERGAS
BORN:	22 August 1952
NATIONALITY:	Australian
EDUCATION:	Sussex University B.A. (Econ.) 1st Class Honours. University of Queensland M.Ec.Stud. (High Distinction)
CURRENT POSITION:	Managing Director The Network Economics Consulting Group Pty Ltd PO Box 5430 Kingston ACT

Employment

1973-76	Senior Tutor in Economics, Macquarie University, Queensland, Australia. Senior Tutor in Economics, University of Queensland, Australia.
1977-78	Fellow (Administrative Trainee), Directorate for Science, Technology and Industry, Organisation for Economic Cooperation and Development (OECD), Paris.
1978-81	Administrator DSTI, OECD, Paris
1981-85	Principal Administrator, Advisory Unit to the Secretary General, OECD, Paris
1985-87	Head, Secretary-General’s Task Force on Structural Adjustment, OECD, Paris.
1987-91	Professor, Graduate School of Management and Head, Information and Communication Technology Studies Program, Monash University.

1991-93	Counsellor for Structural Policy, Economics Department, OECD, Paris.
1993-1996	Advisor, Trade Practices Commission, Canberra, Australia
1993-95	Visiting Professor, Kennedy School of Government, Harvard University.
1995-1997	Inaugural BellSouth NZ Visiting Professor of Network Economics and Communications, The University of Auckland, New Zealand

Other Activities

1983-88	Senior Research Associate, Centre for European Policy Studies, Brussels.
1985-86	Consultant, Department of Communications, Australia
	Consultant, Economic Planning Advisory Council, Australia
1987-90	Consultant, Department of Transport and Communications, Australia
1988-	Consultant, Overseas Telecommunications Corporation Ltd., (as of 1993: Telstra Corporation) Australia
1985-93	Adjunct Professor, Ecole Nationale de la Statistique et de l'Administration Economique, Paris
1990	Visiting Professor, Graduate School of Management, Bocconi University, Milan
1992	Summer Institute Fellow, RAND Corporation, USA
1993-95	Executive Member, Advisory Panel for Telecom 1995, International Telecommunications Union.
1993-95	Member, Steering Group on Cooperative R & D and Technology Diffusion, World Bank.
1993-99	Editorial Board, Information Economics and Policy
1993-	Editorial Board, Communications et Strategies
1994-98	Editorial Board, Telecommunications Policy
1994-95	Consultant, The World Bank
1994-95	Consultant, Critical Technologies Institute, The RAND Corporation, Santa Monica, USA

1997	Member, Advisory Panel on Telecommunications Reform to the Minister for Communications and the Arts, Australia
1998 -	Member, Commissione Scientifica, Telecom Italia, Rome, Italy
1999 – 2001	Chairman, Intellectual Property and Competition Review Committee, Attorney-General's Department, Australia
2001 -	Lay Member of the High Court of New Zealand

Selected Publications (Books And Monographs)

Telecommunications: Pressures and Policies for Change, OECD, 1981.

The Textiles and Clothing Industries, OECD, 1983.

Why Do Some Countries Innovate More Than Others? Centre for European Policy Studies, 1982.

Costs and Benefits of Protection, OECD, 1985.

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Future Structural Options for the INTELSAT System (Co-author: W. Baer), The RAND Corporation, 1995.

Technology Institutions and Policies: Their Role in Developing Technological Capability in Industry, World Bank Technical Paper No. 383, 1997.

Report of the Intellectual Property and Competition Policy Review Committee to the Minister for Industry, Technology and Resources and the Attorney-General; Canberra 2001.

Selected Papers

H Ergas, 2000, The (Uneasy and Somewhat Messy) interaction of the IP Laws and the Competition Laws. A paper presented at the Trade Practices and Consumer Law Conference, Sydney Australia.

H Ergas, 1999, Internet peering: A case study of the ACCC's use of its powers under Part XIB of the Trade Practices Act, 1974.
http://www.necg.com.au/papers-ergas-peering-may99.pdf

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